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In The

Supreme Court of the United States

October Term, 1992

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA,

Petitioner,

vs.

LEONARD HELFAND and EILEEN HELFAND,

Respondents.

On Petition For A Writ Of Certiorari To The California Court Of Appeal, First Appellate District, Division Four

PETITION FOR A WRIT OF CERTIORARI

HORVITZ & LEVY
ELLIS J. HORVITZ
PETER ABRAHAMS *
STEPHEN E. NORRIS
15760 Ventura Boulevard,
18th Floor
Encino, California
91436-3010
(818) 995-0800 and
(213) 872-0802

PETTIT & MARTIN
D. WAYNE JEFFRIES
SAUL D. BERCOVITCH
101 California Street,
35th Floor
San Francisco, California 94111
(415) 434-4000

ROBINSON & WOOD, INC.
ARCHIE S. ROBINSON
THOMAS R. FELLOWS
227 North First Street, Suite 300
San Jose, California 95113
(408) 298-7120

GIBSON, DUNN & CRUTCHER
THEODORE B. OLSON
THEODORE J. BOUTROUS, JR.
JEANNE M. HAUCH
1050 Connecticut Avenue, N.W.
Suite 900
Washington, D.C. 20036
(202) 955-8500

STROOCK & STROOCK & LAVAN
MICHAEL F. PERLIS
2029 Century Park East
Los Angeles, California
90067-3086
(213) 556-5800

Attorneys for Petitioner

* Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

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QUESTION PRESENTED

Does a state court lack subject matter jurisdiction to entertain a collateral attack on and nullify a final order of a United States Bankruptcy Court?

LIST OF PARTIES AND RULE 29.1 LIST

The parties to the proceedings below were Petitioner National Union Fire Insurance Company of Pittsburgh, Pa. ("National Union") and Respondents Leonard and Eileen Helfand.

National Union's parent company is American International Group, Inc. ("AIG"). AIG is affiliated with The Starr Foundation, a charitable foundation, and C.V. Starr & Co. and Starr International Company, Inc., two privately held corporations. The Starr Foundation, C.V. Starr & Co., and Starr International Company, Inc. in the aggregate own approximately 22 percent of AIG's stock.

AIG has numerous wholly-owned subsidiaries. The AIG subsidiaries which are not wholly-owned by AIG and/or another AIG subsidiary are:

Transatlantic Holdings, Inc.

Nan Shan Life Insurance Company, Ltd. (Taiwan)

China America Insurance Company, Ltd.

China America International Insurance Company, Ltd. (Bermuda)

JI Accident & Fire Insurance Co. Ltd. (Japan)

The Philippine American Life Insurance Company (Philippines)

The Philippine American Assurance Company, Inc. (Philippines)

LIST OF PARTIES AND
RULE 29.1 LIST – Continued

Ticino Societa d'Assicurazioni Sulla Vita (Switzerland)

JI Accident & Fire Insurance Co. Ltd. is also a subsidiary of National Union.

National Union's other subsidiaries are wholly-owned.

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PETITION FOR WRIT OF CERTIORARI

National Union Fire Insurance Company of Pittsburgh, Pa. ("National Union") respectfully petitions this Court for a writ of certiorari and requests that the Court summarily reverse the judgment of the California Court of Appeal, First Appellate District, Division Four.

This case involves an extraordinary and highly disruptive encroachment by a California court on the exclusive bankruptcy jurisdiction conferred by the Constitution and the Congress on the federal courts. The California Court of Appeal declared that despite a final order of the United States Bankruptcy Court approving an agreement between National Union and the debtor, Technical Equities Corporation ("Technical Equities") to cancel and revise coverage under the debtor's insurance policy, and finding that the agreement was "in the best interest of the estate and creditors," National Union was nonetheless required by state law to pay claims under the canceled portion of that policy.

Although the bankruptcy court's order has not been challenged in federal court by *anyone*, the court below reasoned that the bankruptcy court's cancellation of the debtor's insurance coverage was "arbitrary" and did not comport with federal bankruptcy procedural rules – rules that the bankruptcy court itself explicitly had found were satisfied. Moreover, the Court of Appeal found that the actions of National Union, authorized by the bankruptcy court, amounted to a breach of the state law implied covenant of good faith and fair dealing under the insurance contract. In subsequent state court insurance bad faith actions against National Union, the trial court

instructed the jury that the cancellation was "invalid, . . . a bankruptcy order to the contrary notwithstanding." The combined judgments against National Union in those bad faith actions exceed $170,000,000, including $43,000,000 in punitive damages.

Because the Court of Appeal's decision raises important questions of federal jurisdiction and amounts to "palpably clear . . . constitutional error," National Union requests that the Court grant a writ of certiorari and summarily reverse the portions of the decision which nullified the bankruptcy court's order. *Eaton v. City of Tulsa*, 415 U.S. 697, 707 (1974) (per curiam) (Rehnquist, J., dissenting); *see, e.g., Florida Dept. of Health & Rehabilitative Servs. v. Florida Nursing Home Ass'n*, 450 U.S. 147 (1981) (per curiam) (summarily reversing where "court below misapplied the prevailing standard for finding waiver of the State's immunity under the Eleventh Amendment").[1]

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[1] *See also Freeport-McMoran Inc. v. K N Energy*, 498 U.S. 426 (1991) (per curiam) (summarily reversing lower court holding that jurisdiction was lacking); *Mireles v. Waco*, 112 S. Ct. 286 (1991) (per curiam) (summarily reversing where lower court wrongly held that defendant judge was not immune from suit); *Commissioner v. McCoy*, 484 U.S. 3 (1987) (per curiam) (summarily reversing tax case because Court of Appeals had no statutory jurisdiction); *Iron Arrow Honor Soc'y v. Heckler*, 464 U.S. 67 (1983) (per curiam) (summarily reversing on ground that Court of Appeals lacked jurisdiction because case was moot).

OPINION AND ORDERS BELOW

The judgment of the trial court is unreported and is reprinted in the appendix at 53a-104a.

The opinion and judgment of the California Court of Appeal is reported at 10 Cal. App. 4th 869, 13 Cal. Rptr. 2d 295 and is reprinted in the appendix at 1a-52a. The order of the California Court of Appeal denying National Union's petition for rehearing is unreported and is reprinted in the appendix at 106a.

The order of the California Supreme Court denying review is unreported and is reprinted in the appendix at 105a.

JURISDICTION

The judgment of the Court of Appeal was entered on October 28, 1992. That court denied a timely petition for rehearing on November 30, 1992. On February 11, 1993, the California Supreme Court denied a timely petition for review. On May 5, 1993, Justice O'Connor ordered that the time for filing a petition for a writ of certiorari be extended to and including June 11, 1993. This Court has jurisdiction over this case under 28 United States Code section 1257(a) (West 1988).

CONSTITUTIONAL PROVISIONS, STATUTES AND RULES INVOLVED

This case principally involves the following provisions of the United States Constitution, federal statutes and rules:

1. The Bankruptcy Clause of the Constitution of the United States, Article I, Section 8, Clause 4, provides:

> The Congress shall have Power To . . . establish . . . uniform Laws on the subject of Bankruptcies throughout the United States. . . .

2. 28 United States Code sections 1334(a), (b) and (d) (West Supp. 1993) provide:

> (a) Except as provided in subsection (b) of this section, the district courts shall have original and exclusive jurisdiction of all cases under title 11.
>
> (b) Notwithstanding any act of Congress that confers exclusive jurisdiction on a court or courts other than the district courts, the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11.
>
> . . . .
>
> (d) The district court in which a case under title 11 is commenced or is pending shall have exclusive jurisdiction of all of the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate.

3. Federal Rules of Civil Procedure 60(b) provides in pertinent part:

> (b) Mistakes; Inadvertence; Excusable Neglect; Newly Discovered Evidence; Fraud, Etc.
>
> On motion and upon such terms as are just, the court may relieve a party or a party's legal representative from a final judgment, order, or

proceeding for the following reasons: (1) mistake, inadvertence, surprise, or excusable neglect; (2) newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial under Rule 59(b); (3) fraud (whether heretofore denominated intrinsic or extrinsic), misrepresentation, or other misconduct of an adverse party; (4) the judgment is void; (5) the judgment has been satisfied, released, or discharged, or a prior judgment upon which it is based has been reversed or otherwise vacated, or it is no longer equitable that the judgment should have prospective application; or (6) any other reason justifying relief from the operation of the judgment. The motion shall be made within a reasonable time, and for reasons (1), (2), and (3) not more than one year after the judgment, order, or proceeding was entered or taken. A motion under this subdivision (b) does not affect the finality of a judgment or suspend its operation. This rule does not limit the power of a court to entertain an independent action to relieve a party from a judgment, order, or proceeding, or to grant relief to a defendant not actually personally notified as provided in Title 28, U.S.C. § 1655, or to set aside a judgment for fraud upon the court. . . .

4. Federal Bankruptcy Rule 9024 provides:

Relief from Judgment or Order

Rule 60 F.R.Civ.P. applies in cases under the Code except that (1) a motion to reopen a case under the Code or for the reconsideration of an order allowing or disallowing a claim against the estate entered without a contest is not subject to the one year limitation prescribed in Rule

60(b), (2) a complaint to revoke a discharge in a chapter 7 liquidation case may be filed only within the time allowed by § 727(e) of the Code, and (3) a complaint to revoke an order confirming a plan may be filed only within the time allowed by § 1144, § 1230, or § 1330.

STATEMENT OF THE CASE

A. The Federal Bankruptcy Proceedings

On August 5, 1984, National Union issued a three-year insurance policy to Technical Equities, a financial services corporation, that provided the company's directors and officers with $10,000,000 in coverage for claims made in each of the policy years from August 1, 1984 through August 1, 1987. Appendix to Petition for a Writ of Certiorari ("App.") at 2a-3a. The policy included a provision that gave both National Union and Technical Equities the right to cancel the policy upon written notice to the other. App. at 30a.

In February 1986, during the second year of the policy's three-year term, Technical Equities filed a petition for reorganization under Chapter 11 of the United States Bankruptcy Code. App. at 27a. Thereafter, Technical Equities' investors, including respondents in this case, filed hundreds of claims for intentional and negligent misrepresentation against the company's pre-bankruptcy directors and officers.[2] Those claims threatened to exhaust the

[2] This declaratory relief action is part of coordinated proceedings in state court that consist of the numerous lawsuits filed following Technical Equities' financial collapse. *See In re*

liability limits of the policy, leaving no coverage for the newly constituted board of directors of the company as debtor-in-possession. To resolve this dilemma, the new board authorized its chairman to negotiate with National Union to obtain $5,000,000 in directors and officers liability coverage for a twelve-month period " 'if no additional premiums need be paid.' " *See* App. at 28a.

Negotiations subsequently produced a carefully crafted agreement between National Union and Technical Equities.[3] In return for the cancellation of the existing policy, effective July 13, 1986 (within the second policy year), National Union agreed to issue a new $5,000,000 policy to cover claims against the members of the new board of directors based on post-bankruptcy acts, App. at 196a-97a, and to require no additional premiums from Technical Equities for such continued coverage. The premiums for the new policy were equal to the unearned premium on the original policy, so nothing was owed by either Technical Equities or National Union. App. at 196a. A portion of the unearned premium also paid for extended coverage under the original policy, i.e., any post-cancellation claims based on pre-bankruptcy acts would be deemed made prior to the July 13 cancellation subject to the second-year policy liability limits. *Id.*

Technical Equities Litig., Master File No. 1991, Santa Clara County Superior Court No. 600306.

[3] National Union initially notified Technical Equities that it was exercising its right to unilaterally cancel upon written notice as provided for in the policy. App. at 27a. That cancellation was never consummated. Instead, the parties entered into the consensual agreement to cancel and replace the policy which was approved by the bankruptcy court.

On July 28, 1986, the bankruptcy court granted Technical Equities' motion for approval of the agreement. The notice of the motion, which was served on each pre-bankruptcy director and officer, stated, inter alia, that "[Technical Equities] shall agree that the Policy has been canceled effective July 13, 1986 . . . . " App. at 196a.

The bankruptcy court explicitly found that adequate notice had been "provided to all parties entitled thereto," App. at 199a, and that the agreement was "in the best interest of the estate and creditors." App. at 200a. The Court of Appeal in this case acknowledged that "[t]he bankruptcy order approving the compromise is final – no one appealed from it or brought a direct attack seeking relief from the order" in the federal courts. App. at 33a.

B. The California State Court Proceedings

1. The Trial Court Decision

Respondents Leonard and Eileen Helfand, two Technical Equities investors, brought this action in state court on November 10, 1986, to obtain a declaration of the amount of coverage available under the original policy.[4] On May 12, 1988, almost two years after the bankruptcy court approved the changes in the debtor's insurance

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[4] In their original complaint, filed four months after the bankruptcy court approved the cancellation, respondents sought only a declaration that defense costs were payable in addition to policy limits. They did not dispute National Union's contention that only the $10,000,000 liability limits under the second policy year were available to satisfy claims against the directors and officers arising out of the financial collapse of Technical Equities.

coverage, respondents amended their complaint to seek a declaration that, despite the bankruptcy court's order, the third year of the original policy remained in effect and therefore provided an additional $10,000,000 in coverage for claims made against the pre-bankruptcy directors and officers during that third year. National Union objected, contending that the federal bankruptcy court had exclusive jurisdiction respecting the changes it had approved in the debtor's insurance coverage, that the bankruptcy order could not be collaterally attacked in state court and that the order conclusively foreclosed as a jurisdictional matter respondents' contention that claims made in the third policy year were covered under the cancelled portion of the policy. App. at 107a-35a.

The trial court rejected these contentions. It ruled that it "is not bound by the Bankruptcy Court's . . . order, even if it purports to authorize the cancellation." App. at 81a.[5] According to the trial court, the cancellation and its approval by the bankruptcy court were invalid because

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[5] The trial court relied on its holdings in this case as authority for its jury instructions in *McLaughlin v. National Union*, A05115 (Cal. Ct. App.) (appeal pending), one of the insurance bad faith actions against National Union in the coordinated state court proceedings. "[T]he trial court instructed the jury: 'Cancellation of the third year of the D&O policy was invalid, *and had no effect on plaintiffs herein, a bankruptcy order to the contrary notwithstanding.*'" App. at 29a-30a, 201a (emphasis added). The combined bad faith judgments against National Union in *McLaughlin* and a subsequent insurance bad faith action in which the trial court gave collateral estoppel effect to the jury verdicts in *McLaughlin* (*Abelson v. National Union*, A05393 (Cal. Ct. App.) (appeal pending)) exceed $170,000,000, including $43,000,000 in punitive damages.

the notice of the bankruptcy court hearing, although served on each director and officer and found sufficient by the bankruptcy court under the bankruptcy rules, was substantively inadequate, in violation of the Due Process Clause. App. at 75a-81a. The trial court found the notice was unconstitutional because it "did not suggest that ten million dollars of insurance coverage would be lost for claims made during the third year, . . . it gave the directors and officers only a few days to respond . . . and [it] was addressed 'To All Interested Parties:' although there was certainly no difficulty in including the names of all the officers and directors in the salutation." App. at 74a. The court also ruled that the bankruptcy court's order did not bind respondents (claimants against the officers and directors) because respondents' interests were not adequately represented by any of the other parties present at the bankruptcy court hearing. App. at 81a-83a. In addition, the court held that because the cancellation was invalid and the policy remained in effect, there was no unearned premium that could be used to purchase the successor policy. According to the court, the post-petition directors and officers were not entitled to coverage under the successor policy unless Technical Equities, the debtor-in-possession, paid National Union a premium of $1,634. App. at 88a.

The effect of the California trial court's ruling was to nullify the bankruptcy court's order approving the agreement that had been reached between National Union and Technical Equities. The court not only held that an additional $10,000,000 in coverage under the original policy was available to pay claims made against the pre-bankruptcy directors and officers in the third policy year, it

also invalidated the provisions of the bankruptcy agreement relating to the successor policy, thereby stripping the new directors of coverage under that policy that had been authorized and approved by the bankruptcy court. *See* App. at 87a-88a.[6]

2. The California Court Of Appeal's Decision

National Union appealed from the trial court's judgment, insisting that the federal bankruptcy court had exclusive jurisdiction over the changes that it had approved in the debtor's insurance coverage and that its order was therefore constitutionally binding on the California courts and immune from collateral attack in state court. App. at 136a-73a. On October 28, 1992, the California Court of Appeal affirmed the trial court's holding that it was not bound by the bankruptcy court's order and that coverage was available under the canceled portion of

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[6] Following entry of the trial court's judgment, National Union filed an action in federal court for an order enjoining further state court proceedings under 28 United States Code section 2283 (West 1990) and 28 United States Code section 1651 (West 1989), which empower a United States District Court to enjoin proceedings in a state court when necessary to protect or effectuate its judgments. The District Court denied the requested relief on the ground National Union's federal constitutional arguments were already pending before the California Court of Appeal in this case. The United States Court of Appeals for the Ninth Circuit summarily affirmed. This Court has noted that "[c]hallenges to the correctness of a state court's determination as to the conclusive effect of a federal judgment must be pursued by way of appeal through the state-court system and certiorari from this Court." *Parsons Steel, Inc. v. First Ala. Bank*, 474 U.S. 518, 525 (1986).

the insurance policy despite the agreement canceling it that had been approved by the bankruptcy court. App. at 27a-51a.

Although the Court of Appeal purported "not [to] classify this lawsuit as a collateral attack on a bankruptcy order," it held that an additional $10,000,000 in coverage was available under the segment of the policy that had been cancelled by the bankruptcy court's order if "National Union did not act in good faith in seeking cancellation" from the bankruptcy court. App. at 34a. The Court of Appeal affirmed the trial court's ruling that, despite the bankruptcy court's explicit finding that adequate notice had been provided pursuant to the bankruptcy rules, the bankruptcy court order violated due process because it did not provide adequate notice to the directors and officers of Technical Equities who had assigned their claims against National Union to respondents. App. at 36a-41a. It also held that respondents, as "non-parties" to the bankruptcy agreement between National Union and Technical Equities who did not personally participate in the hearing on the motion, could not be bound by the bankruptcy order approving the agreement. App. at 42a-46a.

On the basis of its conclusion that the California courts had jurisdiction to sweep aside the bankruptcy order and apply state law, the Court of Appeal declared that National Union's participation in the cancellation of the policy in the federal bankruptcy proceedings constituted a violation of the implied "covenant of good faith and fair dealing" read into insurance contracts by the California courts. App. at 51a. The Court of Appeal acknowledged that the cancellation of the policy made

"sense" as to Technical Equities' creditors "because it favored the debtor's continued existence." App. at 43a. But the court held that the cancellation was nonetheless invalid because it ignored the rights of Technical Equities' former directors and officers and "solely benefitted National Union and Technical Equities, DIP [debtor-in-possession]." App. at 51a.

The court concluded that the cancellation of the policy during bankruptcy was "arbitrary," App. at 50a, and that an "arbitrary cancellation is a breach of the covenant of good faith and fair dealing," App. at 51a, even though (i) National Union had an express, unilateral right to cancel the policy, (ii) it canceled the policy by agreement with the owner of and named insured under the policy, (iii) the unearned premium had been used to purchase coverage for the new directors and officers, and (iv) the bankruptcy court had held that cancellation was consistent with federal bankruptcy law and its obligation to reorganize Technical Equities.

National Union filed a petition for rehearing asking the Court of Appeal to delete its conclusion that National Union had violated the implied covenant of good faith and fair dealing by participating in the bankruptcy agreement canceling the policy. App. at 174a-76a. It urged the Court of Appeal to "avoid . . . a decision [infringing] on the exclusive jurisdiction of a federal court and [violating] principles of federal-state comity," App. at 174a, and that "any holding that the bankruptcy court sanctioned a bad faith cancellation necessarily constitutes a collateral attack on the bankruptcy order." App. at 175a. On November 30, 1992, the Court of Appeal summarily denied the petition for rehearing. App. at 106a.

National Union filed a petition for review in the California Supreme Court, raising the same federal questions it had raised before the Court of Appeal. App. at 177a-93a. The California Supreme Court summarily denied the petition for review on February 11, 1993, with one justice voting to grant review. App. at 105a.

REASON FOR GRANTING THE WRIT

The California Courts Lacked Subject Matter Jurisdiction As A Matter Of Federal Law To Entertain A Collateral Attack On The Bankruptcy Court Order Because The Validity Of A Final Order Permitting A Debtor In Bankruptcy To Amend, Modify Or Cancel A Contract Falls Within The Exclusive Jurisdiction Of The Federal Courts

The California courts clearly lacked subject matter jurisdiction to determine whether the National Union policy had been validly cancelled. Under the Bankruptcy Clause of the Constitution of the United States and the statutes enacted by Congress thereunder, the federal courts have exclusive jurisdiction over that issue. This Court should therefore grant a writ of certiorari and summarily reverse that portion of the Court of Appeal's decision that nullified the bankruptcy court's order.

The Constitution expressly confers on Congress the "[p]ower . . . [t]o establish . . . uniform laws on the subject of bankruptcies throughout the United States." U.S. Const., art. I, § 8, cl. 4. Pursuant to this authority, Congress has promulgated the United States Bankruptcy Code, *see* 11 U.S.C. § 101, et seq. (West 1988); created the United States Bankruptcy Courts, *see* 28 U.S.C. §§ 157-58 (West 1988); vested exclusive jurisdiction in the federal

courts to enforce the bankruptcy laws and to hear bankruptcy cases, *see, e.g.*, 28 U.S.C. § 1334(a) (West 1988) ("the district courts shall have original and exclusive jurisdiction of all cases under title 11"); 28 U.S.C. § 1334(d) ("The district court in which a case under Title 11 is commenced or is pending shall have exclusive jurisdiction of all of the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate"); and established detailed and comprehensive procedural rules to govern bankruptcy proceedings and litigation. *See, e.g.*, Federal Bankruptcy Rules.

Congress' exclusive grant of jurisdiction to the federal courts plainly precludes state courts from asserting jurisdiction over matters that are within the province of, and have been determined by, the federal bankruptcy courts.[7] As this court has held, "[t]he Constitution grants Congress exclusive power to regulate bankruptcy and under this power Congress can limit the jurisdiction

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[7] Proceedings in bankruptcy are proceedings in rem, *In re Met-L-Wood Corp.*, 861 F.2d 1012, 1017 (7th Cir. 1988), *cert. denied sub nom. Gekas v. Pipin*, 490 U.S. 1006 (1989); *Chapel v. First Trust Co.*, 30 F. Supp. 765, 766 (E.D. Wis. 1940), and a debtor's insurance policies, which are part of the estate, are within the bankruptcy court's exclusive in rem jurisdiction, *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 91 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988); *In re Minoco Group of Cos.*, 799 F.2d 517, 519 (9th Cir. 1986). A bankruptcy court clearly has the power to make orders regarding a debtor's property that favor its "continued existence," *see* App. at 43a, including modification and termination of the debtor's insurance and other contracts. "In fact, the very essence of bankruptcy laws is the modification or impairment of contractual obligations." *In re Webber*, 674 F.2d 796, 802 (9th Cir. 1982).

which courts, state or federal, can exercise over the person and property of a debtor who duly invokes the bankruptcy law." *Kalb v. Feuerstein*, 308 U.S. 433, 439 (1940). In *Kalb*, a state court had rejected the argument that it lacked subject matter jurisdiction to foreclose on property that fell within the federal bankruptcy jurisdiction. The Court held that Congress' vesting of exclusive jurisdiction in the federal courts pursuant to the Bankruptcy Clause "oust[ed] the jurisdiction of the State court," rendering the state judgment "not merely erroneous but . . . beyond [the state court's] power, void." *Id.* at 438. The "States cannot, in the exercise of control over local laws and practice, vest State courts with power to violate the supreme law of the land." *Id.*

This Court recently reiterated that the holding in *Kalb* rested "on Congress' exclusive right to regulate bankruptcy, which gave it the power to vest jurisdiction over bankruptcy proceedings exclusively in one forum and to withdraw that jurisdiction from all other forums, and Congress' statutory exercise of that right." *International Longshoremen's Ass'n v. Davis*, 476 U.S. 380, 393 n.11 (1986) (a case "strikingly similar" to *Kalb*; applying *Kalb* and finding that jurisdictional pre-emption of state law under the National Labor Relations Act meant that "the state court had *no power* to adjudicate the subject matter of the case") (emphasis added) *Id.* at 393 & n.11; *see also United States v. Williams*, 341 U.S. 58, 67 (1951) (because federal government, "in the exercise of its plenary power over bankruptcy had ousted state courts of all independent power over farmer bankrupts . . . any subsequent orders in the state courts were void") (citing *Kalb*); *Marine Harbor Properties, Inc. v. Manufacturer's Trust Co.*, 317 U.S. 78, 83

(1942) ("The federal bankruptcy power is, of course, paramount and supreme and may be so exercised by Congress as to exclude every competing or conflicting proceeding in state or federal tribunals") (citing *Kalb*); cf. *White v. Schloerb*, 178 U.S. 542, 547 (1900) (" 'After an adjudication in bankruptcy an action of replevin in a state court cannot be commenced and maintained against the bankrupt to recover property in the possession of and claimed by the bankrupt at the time of that adjudication, and in the possession of a referee in bankruptcy at the time when the action of replevin is begun' "); *In re South Beardstown Drainage & Levee Dist.*, 125 F.2d 13, 15 (7th Cir. 1941) ("The Constitutional provision which gave to Congress the power to enact uniform bankruptcy legislation made the Federal Bankruptcy Law, the exclusive and dominant law of the land on the subject of bankruptcy. As a corollary, it necessitated a recognition of the paramount and exclusive jurisdiction of the Federal courts in matters of bankruptcy, when that jurisdiction is properly invoked").

The federal courts of appeals have recognized that "[t]he ability collaterally to attack bankruptcy petitions in the state courts would . . . threaten the uniformity of federal bankruptcy law, a uniformity required by the Constitution." *Gonzales v. Parks*, 830 F.2d 1033, 1035 (9th Cir. 1987). Thus, in *Gonzales*, the Ninth Circuit held that it would violate the Bankruptcy Clause of the Constitution to permit collateral attacks on federal bankruptcy orders in state court. In that case, a creditor filed a tort action in California state court, alleging that a debtor's prior federal bankruptcy filing constituted a tortious abuse of process, and the state court entered judgment for the creditor. 830 F.2d at 1033-34. The debtor then sought relief

from the state court judgment in the federal bankruptcy court, which vacated the state judgment.

The Ninth Circuit affirmed, holding that the state courts lacked subject matter jurisdiction to hear a claim relating to a federal bankruptcy petition, because "[f]ilings of bankruptcy petitions are a matter of exclusive federal jurisdiction." *Id.* at 1035. It declared that state courts simply may not intervene, at any stage, in matters that fall within the federal bankruptcy jurisdiction: "State courts are not authorized to determine whether a person's claim for relief under a federal law, in a federal court, and within that court's exclusive jurisdiction, is an appropriate one. Such an exercise of authority would be inconsistent with and subvert the exclusive jurisdiction of the federal courts by allowing state courts to create their own standards as to when persons may properly seek relief in cases Congress has specifically precluded those courts from adjudicating." *Id.*[8] Put slightly differently,

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[8] *See also Gene R. Smith Corp. v. Terry's Tractor, Inc.*, 209 Cal. App. 3d 951, 257 Cal. Rptr. 598 (1989), *cert. denied*, 494 U.S. 1016 (1990) (dismissing because exclusive federal bankruptcy jurisdiction precluded collateral challenge); *Idell v. Goodman*, 224 Cal. App. 3d 262, 273 Cal. Rptr. 605 (1990) (malicious prosecution action preempted by federal bankruptcy law); *Cassidy v. Kentner*, 600 N.E.2d 1200, 1201 (Ill. Ct. App. 1992) (dismissing because "[i]t is clear that this court lacks any power to review the correctness of the rulings of a federal bankruptcy court"); *Prososki v. Commercial Nat'l Bank & Trust Co.*, 365 N.W.2d 427, 429 (Neb. 1985) (appropriate procedure to test bankruptcy court action is by appeal to federal district court and not by filing independent action in state court); *Reldan Trading Corp. v. ABC Films, Inc.*, 196 N.Y.S.2d 270 (N.Y. Sup. Ct. 1959) (dismissing action on grounds that federal bankruptcy court had jurisdiction).

state courts lack the power to disregard and must fully respect a bankruptcy court order. *Stoll v. Gottlieb*, 305 U.S. 165, 170-71 (1938).

The availability of a panoply of post-judgment remedies from final bankruptcy orders in federal court confirms that Congress did not intend – and the Constitution will not permit – state courts to assert jurisdiction to entertain collateral challenges, of any kind or under any circumstances, to federal orders that fall within the exclusive federal bankruptcy jurisdiction. *See Gonzales*, 830 F.2d at 1035 ("That Congress' grant to the federal courts of exclusive jurisdiction over bankruptcy petitions precludes collateral attacks . . . in state court is supported by the fact that remedies have been made available in federal court"). The Federal Bankruptcy Rules incorporate by reference the post-judgment remedies afforded by the Federal Rules of Civil Procedure. *See, e.g.*, Fed. Bank. R. 9023 (applying Rule 59(e) of Fed. R. Civ. P. authorizing motions to alter or amend the judgment to bankruptcy proceedings); *see also Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. Partnership*, 113 S. Ct. 1489 (1993) (creditor entitled to relief pursuant to Fed. Bank. R. 9006(b)(1) from its attorney's failure to file claim within bar date where the notice of the bar date was inconspicuously placed in a notice regarding a creditors' meeting). Moreover, an aggrieved creditor may appeal a final bankruptcy court order, first to a federal district court and then to a federal court of appeals, 28 U.S.C. § 158 (West 1988), and a non-party whose interests are potentially at stake may intervene during the federal appellate proceedings to protect those interests. *See* Fed. Bank. R. 2018(a) (court may permit any interested party to intervene); *Yniguez v. State of*

Arizona, 939 F.2d 727, 731-32 (9th Cir. 1991) (person who did not participate below may intervene on appeal where person's interests not adequately represented by other parties).

Further, where, as here, persons claim that they did not receive notice sufficient to permit them fully and adequately to participate in the federal bankruptcy court proceedings prior to the expiration of the time for filing an appeal, a federal remedy exists under Federal Rules of Civil Procedure 60(b), as incorporated by Rule 9024 of the Federal Bankruptcy Rules. *See, e.g., In re Barnes*, 969 F.2d 526, 527 (7th Cir. 1992) ("The usual motion to reopen a proceeding in which the judgment has become final is a collateral attack on the judgment and is therefore subject, in bankruptcy as in other federal cases, to the strict limitations of Rule 60(b)"); *In re Edwards*, 962 F.2d 641, 644 (7th Cir. 1992) ("collateral relief from an order approving a bankruptcy sale is governed by the standards of Rule 60(b)"); *In re Tek-Aids Indus., Inc.*, 145 Bankr. 253, 258 (N.D. Ill. 1992) (granting Rule 60(b) relief from final bankruptcy judgment because creditors did not receive notice).

To permit subsequent collateral attacks in state court on federal bankruptcy court orders would seriously undermine the paramount principle of finality in federal bankruptcy law. As the First Circuit has explained: "In order efficiently to administer the estate, a trustee's court-approved settlement must have finality, and settling parties must be assured that those the trustee represents will not relitigate settled claims." *In re Medomak Canning*, 922 F.2d 895, 901 (1st Cir. 1990). Thus, "[a] strong interest to achieve finality pervades Chapter 11 arrangements." *Oneida Motor Freight v. United Jersey Bank*,

848 F.2d 414, 417 (3d Cir.), *cert. denied*, 488 U.S. 967 (1988); *see also Edwards*, 962 F.2d at 645 (discussing the "strong policy of finality of bankruptcy sales"); *Hendrick v. Avent*, 891 F.2d 583, 587 n.9 (5th Cir.), *cert. denied*, 498 U.S. 819 (1990) (recognizing "the important interest in the finality of judgments in a bankruptcy case.").

To ensure finality, the federal courts of appeals have established strict limits on the power of even the federal courts to set aside final bankruptcy court orders. Such complaints generally must be made, if at all, pursuant to Rule 60(b), subject to rigorous procedural requirements. *Edwards*, 962 F.2d at 642, 645 (creditor who claimed lack of notice of bankruptcy sale barred from challenging bankruptcy court's order, except by proper Rule 60(b) motion); *Hendrick v. Avent*, 891 F.2d at 585-87 (creditor who alleged it was the victim of misrepresentations during bankruptcy proceedings that resulted in sale of property was prohibited from bringing separate action because Rule 60(b) is the only proper method of attacking final judgment); *Sure-Snap Corp. v. State Street Bank & Trust Co.*, 948 F.2d 869 (2d Cir. 1991) (separate tort suit relating to bankruptcy disposition impermissible).

Respondents in this case ignored the remedies available to them in federal court and instead sought out a more receptive forum in state court, where the need to balance the "property rights on both sides of the equation," *Edwards*, 962 F.2d at 645, and the unique purposes and policies of the federal bankruptcy law would not constrain the inquiry.[9] But the California courts had no

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[9] A person dissatisfied by a bankruptcy court ruling is more likely to find a sympathetic ear in state than in federal

jurisdiction either to evaluate the substantive merits of the agreement between the bankruptcy debtor and National Union or to question the procedural fairness of the federal proceedings relating to a matter that falls within the exclusive jurisdiction of the federal courts.[10]

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court. As this case illustrates, the state and federal courts will frequently be concerned with vindicating different rights. In some cases, the conflict between the respective concerns of the state and federal courts can be dramatic, and the incentive to disregard a bankruptcy court order overwhelming. In *Kamstra v. Kent County Treasurer*, 51 B.R. 826 (1985), for example, the bankruptcy court granted the trustee's request to subordinate city and county tax liens on the debtor's property to the estate's administrative expenses. The effect of the order was to totally extinguish the liens. The bankruptcy court rejected the city's and county's contention that it was impermissibly intruding on their interest in revenues in violation of the Tenth Amendment. It explained that the authority to subordinate the liens was included within its "power to discharge the debtor from his contracts and legal liabilities as well as to distribute his property." A state court, which depends for its continued functioning on tax revenues, would have doubtless given more credence to the city's and county's position.

[10] The Court of Appeal claimed it was not sanctioning a collateral attack on the bankruptcy court order because that order – discontinuing one insurance policy and installing another – did not "impact or determine rights as between the insurer and its insureds." App. at 33a, *see also* App. at 35a. But the bankruptcy order plainly determined such rights. By approving the agreement between the debtor and National Union canceling the policy during the second policy year, the bankruptcy court necessarily determined the rights of the debtor's former directors and officers in the proceeds of the third policy year. Moreover, unless the agreement relieved National Union of its obligations under the third policy year, it would have never issued the successor policy: there would have

The California Court of Appeal's determination henceforth to entertain collateral attacks on final bankruptcy court orders has enormous practical significance. Once a petition seeking protection under Chapter 11 of the Bankruptcy Code is filed, "keeping the bankrupt in operation is difficult." *In re Met-L-Wood Corp.*, 861 F.2d at 1017. A bankruptcy court must have the ability to approve *binding* agreements with third parties for services and supplies necessary to sustain the debtor's continued existence. *Id.* at 1019. One of the first challenges faced by a corporate debtor is obtaining insurance coverage for its directors and officers. Without such coverage, the corporation is unlikely to attract directors and officers willing to guide the corporation through reorganization. *In re Minoco Group of Cos.*, 799 F.2d at 518; *In re Baldwin-United Corp.*, 43 B.R. 443, 447 (Bankr. S.D. Ohio 1984) (discussing importance of insuring that debtors can obtain adequate insurance for post-petition directors and officers).

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been no unearned premium to return and therefore no consideration for that policy.

Further, the Court of Appeal found that the agreement between the debtor and National Union which was approved by the bankruptcy court was "arbitrary," concluded that National Union's participation in the bankruptcy proceedings, in and of itself, constituted a breach of the state law implied covenant of good faith and fair dealing, and approved the trial court's conclusion that no coverage was available under the successor policy unless the debtor-in-possession paid an additional premium, even though the bankruptcy court had authorized the issuance of the policy without the payment of a premium. If these rulings do not constitute a collateral attack, and an impermissible interference with a federal court judgment, it is hard to imagine what would.

Here, the bankruptcy court obtained coverage for the debtor's newly constituted board of directors by approving an agreement that called for the cancellation of the existing policy and using the unearned premium to purchase a policy covering the new board. If state courts were empowered to set aside such orders (and find in addition that insurers that rely on them can violate a state law implied covenant of good faith and fair dealing), no insurer would agree to cancel a debtor's policy in return for the issuance of a new policy, even if a bankruptcy court found the new policy was essential to the debtor's continued existence. Moreover, the Court of Appeal's decision in this case is not limited to bankruptcy orders relating to insurance policies but rather opens up all orders disposing of property to potential collateral challenge in state court if it can be argued that the order gives insufficient consideration to the interests of third persons.

This Court should grant the writ and summarily reverse. First, the California Court of Appeal's decision is manifestly wrong and outside that court's jurisdiction. Second, the question whether state courts may exercise collateral review of a federal judgment where Congress has declined to vest such courts with jurisdiction to consider directly the subject matter of the federal claims is important, substantial and recurring. Indeed, if allowed to stand, the published opinion of a Court of Appeal in the Nation's largest State in this case no doubt will materially frustrate and intrude on the exclusive jurisdiction of the federal courts to resolve bankruptcy matters and will defeat the uniformity of federal bankruptcy law that is explicitly directed by the Bankruptcy Clause of the Constitution.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be granted and the portion of the judgment of the California Court of Appeal that nullified the bankruptcy court's order should be summarily reversed.

Respectfully submitted,

HORVITZ & LEVY
ELLIS J. HORVITZ
PETER ABRAHAMS *
STEPHEN E. NORRIS
GIBSON, DUNN & CRUTCHER
THEODORE B. OLSON
THEODORE J. BOUTROUS, JR.
JEANNE M. HAUCH
PETTIT & MARTIN
D. WAYNE JEFFRIES
SAUL D. BERCOVITCH
STROOCK & STROOCK & LAVAN
MICHAEL F. PERLIS
ROBINSON & WOOD, INC.
ARCHIE S. ROBINSON
THOMAS R. FELLOWS

Counsel for Petitioner
National Union Fire Insurance
Company of Pittsburgh, PA

* Counsel of Record

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No. 92-___

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In The

Supreme Court of the United States

October Term, 1992

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.,

Petitioner,

vs.

LEONARD HELFAND, et al.,

Respondents.

On Petition For A Writ Of Certiorari To The California Court Of Appeal, First Appellate District, Division Four

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

ELLIS J. HORVITZ
PETER ABRAHAMS*
STEPHEN E. NORRIS
HORVITZ & LEVY
15760 Ventura Boulevard, 18th Floor
Encino, California 91436
(818) 995-0800 and (213) 872-0802

Counsel for Petitioner, National Union Fire Insurance Company of Pittsburgh, PA.

*Counsel of Record

(Additional Counsel Listed On Inside Cover)

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

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Pettit & Martin
D. Wayne Jeffries
Saul D. Bercovitch
101 California Street, 35th Floor
San Francisco, California 94111
(415) 434-4000

Stroock & Stroock & Lavan
Michael F. Perlis
2029 Century Park East
Los Angeles, California 90067-3086
(213) 556-5800

Gibson, Dunn & Crutcher
Theodore B. Olson
Theodore J. Boutrous, Jr.
Jeanne M. Hauch
1050 Connecticut Avenue, S.W.
Suite 900
Washington, D.C. 20036
(202) 955-8500

Robinson & Wood, Inc.
Archie S. Robinson
Thomas R. Fellows
227 North First Street, Suite 300
San Jose, California 95113
(408) 298-7120

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[No. A049442, First Dist., Div. Four. Oct. 28, 1992.]

LEONARD HELFAND et al., Plaintiffs and Respondents, v. NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA., Defendant and Appellant.

COUNSEL

Pettit & Martin, D. Wayne Jeffries, Saul D. Bercovitch, Robinson & Wood, Archie S. Robinson, Thomas R. Fellows, Stroock & Stroock & Lavan, Michael F. Perlis, Horvitz & Levy, Ellis J. Horvitz and Peter Abrahams for Defendant and Appellant.

Ross, Dixon & Masback, Barbara E. Etkind and F. Clinton Broden as Amici Curiae on behalf of Defendant and Appellant.

Cotchett, Illston & Pitre, Joseph W. Cotchett, Susan Illston, Marie Seth Weiner, Morgan, Ruby, Schofield, Franich & Fredkin, Allen J. Ruby and Lexie D. Schroeder, Remcho, Johansen & Purcell, Joseph Remcho, Robin B. Johansen, Karen Getman, Wendy S. Stimling, Thomas T. Anderson, Samuel Trussell, Crosby, Heafey, Roach & May, Ronald L. Murov, Howard A. Janssen, Severson & Werson, Gerald J. Buchwald, Michael B. Murphy and Elizabeth A. Syufy, for Plaintiffs and Respondents.

OPINION

ANDERSON, P.J. –

I. INTRODUCTION AND BACKGROUND

This appeal is but one round in the complex, bitter legal battle between the defrauded investors of Technical

Equities Corporation (Technical Equities) and its insurer – appellant National Union Fire Insurance Company of Pittsburgh, Pa. (National Union). At stake are millions of dollars in insurance proceeds to pay for claims which the investors pursued against the officers and directors of Technical Equities and over $140 million in damages later assessed against National Union.

National Union is the liability insurer of the directors and officers[1] of Technical Equities. Respondents Leonard and Eileen Helfand (plaintiffs) invested in securities offered by Technical Equities only to find their investment substantially worthless after the company's financial collapse and bankruptcy. Hundreds of investors like plaintiffs have sued the company's directors and officers; multiple judgments have been entered in these suits against them for economic losses, emotional distress and prejudgment interest.

Plaintiffs' action[2] is for declaratory relief to determine the scope of coverage under the "Directors and Officers Liability and Corporation Reimbursement" policy of insurance which Technical Equities took out with National Union for the three-year period from August 1, 1984, to August 1, 1987. Technical Equities prepaid its

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[1] We sometimes abbreviate "directors and officers" as D&O.

[2] In addition to National Union, plaintiffs also named as defendants those individuals who were directors and officers of Technical Equities at the relevant times. All of the named former directors of Technical Equities and all but two of the named officers cross-complained against National Union for declaratory relief on the issues of defense costs and the policy's liability limits.

$30,290 premium in return for $10 million in coverage for each policy year.

National Union concedes there is $10 million in coverage for the second policy year. At issue is whether there is coverage under the first and third policy years, and whether the policy itself is a wasting asset, so that defense costs are included within the policy limits of $10 million per year.

The trial court ruled against National Union on all three issues. The judgment in this case and in the companion case of Chatton v. National Union (Super. Ct. Santa Clara County, 1991, No. 600306) (involving coverage under a comprehensive general liability (CGL) policy) set the stage for two insurance bad faith suits against National Union brought on a coordinated basis by over 500 investors. McLaughlin et al. v. National Union (Super. Ct. Santa Clara County, 1991, No. 666839), combining seven plaintiff groups on a test case basis, resulted in judgment against National Union for $48,943,165.45, including $43 million in punitive damages for all plaintiffs. Abelson v. National Union (Super. Ct. Santa Clara County, 1991, No. 666840), in which National Union was found liable to all remaining plaintiffs, resulted in judgment of $120,500,181. (both Mclaughlin and Abelson are also on appeal, albeit not yet fully briefed.)

We conclude that (1) defense costs reduce the policy's liability limits and (2) there is $20 million available under the policy to pay for second and third year claims. Accordingly, we reverse in part and affirm in part.

II. Defense Costs Are Included Within the Liability Limits

A. *Introduction*

National Union's first challenge is to the trial court's ruling that defense costs do not deplete the limits of liability available under the policy to pay for claims. Upon reconsideration of its summary adjudication ruling, the court concluded: "The National Union 1984-1987 D&O policy is not 'wasting' or 'self-consuming,' and National Union is obligated to pay the reasonable costs, charges and expenses of defense, including attorneys' fees of an insured under the policy, in addition to the limit of liability." The court reasoned that any "self-consuming" provisions were contrary to the reasonable expectations of the insureds, as a matter of law. Moreover, it concluded the policy was ambiguous, "such that a normal insured would not be aware of its 'self-consuming' nature."

The defense obligations of D&O carriers typically differ in nature and scope from the defense obligations of general liability carriers. For example, D&O policies generally do not obligate the carrier to provide the insured with a defense. More likely, they require the carrier to reimburse the insured for defense costs as an ingredient of "loss," a defined term under the policy. (See 1 Hutcheon & Thompson, Business Insurance Law and Practice Guide (Matthew Bender ed. 1992) Directors' & Officers' Liability Insurance, § 3.06[1]; Knepper & Bailey, Liability of Corporate Officers and Directors (4th ed. 1988) Liability Insurance § 21.09, pp. 705-709; Harley, Directors' and Officers' Liability Insurance (PLI ed. 1990) pp. 326-329.) This being the case, it is the insured, or the

insured with the mutual agreement of the insurer, who selects defense counsel and controls the defense of the underlying case.

How the carrier's reimbursement obligation specifically interfaces with the limits of liability in a given D&O policy can only be determined by examining the language of that policy. This we do hand in hand with the familiar tools of contract interpretation.

The overriding goal of contract interpretation is to give effect to the parties' mutual intentions as of the time of contracting. (Civ. Code, § 1636.) Where contract language is clear and explicit and does not lead to an absurd result, we ascertain this intent from the written provisions and go no further. (Civ. Code, §§ 1638, 1639; *AIU Ins. Co. v. Superior Court* (1990) 51 Cal.3d 807, 822 [274 Cal.Rptr. 820, 799 P.2d 1253].) The words of a contract generally are to be understood in their ordinary and popular sense unless the parties use them in a technical sense or "a special meaning is given to them by usage. . . ." (Civ. Code, § 1644.)

However, if the terms of a contractual promise are ambiguous or uncertain, we must interpret the promise "in the sense in which the promisor believed, at the time of making it, that the promisee understood it." (Civ. Code, § 1649.) "This rule, as applied to a promise of coverage in an insurance policy, protects . . . 'the objectively reasonable expectations of the insured.' " (*Bank of the West v. Superior Court* (1992) 2 Cal.4th 1254, 1265 [10 Cal.Rptr.2d 538, 833 P.2d 545].) If use of this rule does not eliminate the uncertainty, then we construe the applicable language against the insurer, the drafter who created the

uncertain language in the first place. (*Ibid.*; Civ. Code, § 1654.)

A policy provision is ambiguous if it is capable of more than one reasonable construction. (*Producers Dairy Delivery Co. v Sentry Ins. Co.* (1986) 41 Cal.3d 903, 912 [226 Cal.Rptr. 558, 718 P.2d 920].) However, we will not strain the policy language to create an ambiguity. (*Ibid.*) Moreover, we will not label a provision ambiguous simply upon isolating phrases and considering them in the abstract. Rather, we must construe the provision in relation to the whole of the instrument, with each clause giving meaning to the other. (*Id.*, at pp. 916-917 and fn. 7; Civ. Code, § 1641.)

B. *Discussion*

Our analysis of this D&O policy uncovers no ambiguity concerning its "self-consuming" nature. The plain terms of the policy make it clear that defense costs are payable against the limits of liability just like any other element of "loss"[3] as defined in the policy. We arrive at this conclusion by examining the policy as a whole and

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[3] The policy defines "loss" as "any amount which the insureds are legally obligated to pay for a claim or claims made against them for Wrongful Acts, and shall include damages, judgments, settlements, costs, charges and expenses (excluding salaries of officers or employees of the Company) incurred in the defense of actions, suits or proceedings and appeals therefrom; provided always that such subject of loss shall not include fines or penalties imposed by law or other matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed."

the interplay between the defined concept of "loss" and various related provisions.

First, in the insuring clause National Union promises to pay on behalf of the insured officers and directors "*against loss* . . . arising from any claim or claims which are first made against the Insureds . . . during the policy period by reason of any Wrongful Act . . . in their respective capacities as Directors or Officers." (Italics added.) Next, clause 5 (titled "LIMIT AND RETENTION"), paragraph (b) as amended states: "[T]he Insurer's liability for any claim or claims made against it shall . . . be the amount stated in Item 3 of the Declarations which shall be the maximum liability of the Insurer in (a) each policy year. . . . " Item No. 3 of the Declarations in turn reads: "LIMIT OF LIABILITY: $10,000,000 each policy year. . . . "

Finally, endorsement No. 3, captioned "COSTS, CHARGES AND EXPENSES AND DEFENSE INCLUDED IN LIMIT OF LIABILITY" replaces the predecessor clause No. 6 (captioned only "COSTS, CHARGES AND EXPENSES AND DEFENSE") in its entirety. It states in pertinent part that when a payment not exceeding "the Limit of Liability has to be made to dispose of a claim, costs, charges, expenses and settlements shall be payable up to the Limit of Liability. . . . "[4]

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[4] Endorsement No. 3 reads: "(a) No costs, charges, expenses and settlements shall be incurred without the Insurer's consent which shall not be unreasonably withheld; however, in the event such consent being given, the Insurer will pay, subject to the provisions of Clauses 5(b) and 5(c) [relating to retentions], 95% of all such costs, charges, expenses and settlements, subject nevertheless to the following conditions:

From these provisions it is apparent that the term "loss" is the dollar amount which a director or officer must pay for a claim, and that such amount embraces damages as well as the costs of defense. It is further apparent that National Union's maximum liability for claims is $10 million in each policy year. Finally, when payment not exceeding the limit of liability must be made to dispose of a claim, costs, charges expenses and settlements are payable up to the limit of liability. We agree with National Union that these provisions are clear and reasonably mean only one thing: *defense costs accrue against the policy's limit of liability.*

Plaintiffs first counter that the issue whether the D&O policy is self-consuming is moot because defense costs have been paid from and allocated to the CGL policy, and the D&O policy expressly excludes coverage for payment on claims insured by another policy. They rely on testimony and a colloquy between the court and national Union's counsel during the Chatton trial. This testimony showed that some $23 million apparently was booked to the CGL policy. However, prior to the court's ruling on the self-consuming issue in this case, some $1.5 million was charged against the D&O policy, and *all* costs of defending directors against criminal proceedings have been charged against the D&O policy. More importantly, National Union deserves appellate review of the self-

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[¶](i) If a payment not in excess of the Limit of Liability has to be made to dispose of a claim, costs, charges, expenses and settlements shall be payable up to the Limit of Liability applicable under this policy. [¶](ii) If the claim is successfully resisted by the Insureds, costs, charges and expenses shall be payable up to but not exceeding the Limit of Liability under this policy."

consuming issue because the jury in McLaughlin was instructed that the D&O policy as not wasting asset, and presumably those instructions were taken into account when the jury found National Union liable for bad faith.

Plaintiffs next argue that contrary to National Union's assertions, the policy does not link the limit of liability to the term "loss," but rather defines the limit of liability as a ceiling for claims, a term nowhere defined in the policy. This argument is superficial. What we do know about a claim – namely, that it results in a "loss," i.e., an *amount*, with defined components (e.g., damages, defense costs), which the director or officer has to pay for having committed a wrongful act – leads one to conclude that for all practical purposes the concept of a claim is subsumed within the definition of loss.

Plaintiffs further contend that the endorsement No. 3(a)(i) language that costs of defense "shall be payable up to the Limit of Liability" is ambiguous. They posit that it could mean that these costs would be paid separately up to the limit, i.e., there is a $30 million cap on coverage for claims and an additional $30 million cap on defense costs. This is an absurd interpretation – one which could not possibly, let alone reasonably, stem from a policy which defines defense costs as an element of loss and which states in the capitalized title to the endorsement that defense costs are "included in limit of liability."

Then, in their response to the amicus curiae brief of Continental Casualty Company, plaintiffs also argue that endorsement No. 3 completely removes the original paragraph's restriction on defense costs in the present circumstances where payment to dispose of a claim will *exceed*

the policy's limit of liability.[5] The original clause provided that in such cases National Union had to pay defense costs *over and above* the limit of liability, but only on a pro rata basis. The new clause per endorsement No. 3 does not specifically address the situation where losses exceed the limit of liability. Thus, plaintiffs urge that the broad language of endorsement No. 3, paragraph (a) applies, requiring National Union to pay 95 percent of all defense costs, there being no other cap.

But there is another cap. Plaintiffs ignore the fact that the broad endorsing language of paragraph (a) also subjects National Union's obligation to pay defense costs to the provisions of clause 5(b), which state that the insurer's cap on liability for any claim is $10 million each policy year. They gloss over this connection with the remark that clause 5(b) does not provide any further restriction on National Union's obligation to pay defense costs because it deals with National Union's responsibility for payment of claims! But it is precisely this

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[5] In this same brief plaintiffs point out that contrary to the original policy language, this same endorsement adds a *new restriction* to National Union's obligation to pay defense costs – namely, that when National Union is called upon to pay *less than* the limit of liability, it is no longer required to pay defense costs over and above that limit. The original language read: "If a payment not in excess of the limit of liability has to be made to dispose of a claim, costs, charges, and expenses shall be payable *in addition to* the limit of liability otherwise applicable under this policy." (Italics added.)

Plaintiffs' interpretation here goes against the very argument presented in their opening brief and discussed above that the endorsement No. 3(a)(i) language is ambiguous. (The two briefs were prepared by different law firms.)

connection to the cap on liability for losses from claims that defeats plaintiff's argument – there is $10 million per year, period, to pay for such losses, and under the policy that $10 million can be used for any component of the loss, including damages and defense costs.

Plaintiffs also maintain that National Union knows how to be clear when it wants to, quoting from a revised D&O policy used *after* 1984: The following notice appears at the top of the declarations page: "NOTICE: THE LIMIT OF LIABILITY AVAILABLE TO PAY JUDGMENTS OR SETTLEMENTS SHALL BE REDUCED BY AMOUNTS INCURRED FOR LEGAL DEFENSE. FURTHER NOTE THAT AMOUNTS INCURRED FOR LEGAL DEFENSE SHALL BE APPLIED AGAINST THE RETENTION AMOUNT." We agree that this statement is simpler and clearer than the statement in question. However, the policy, read as a whole, is not legally ambiguous on whether defense costs apply against coverage limits.

Plaintiffs next argue that case law supports their conclusion that defense costs do not deplete policy limits. (Citing *Planet Ins. Co. v. Mead Reinsurance Corp.* (9th Cir. 1986) 789 F.2d 668; *Grunewald & Adams v. Lloyds of London* (Ariz.App. 1985) 700 P.2d 888; *Hertzka & Knowles v. Salter* (1970) 6 Cal.App.3d 325 [86 Cal.Rptr. 23].) These decisions do not aid their cause.

It is true that the reviewing court in each case rejected the insurer's argument that defense costs diminished the insured principal sum. However, it is equally true that in each case there was a linguistic basis for interpreting the policy in favor of the insured on this key

point.[6] We do not have an ambiguous policy here, and the language plainly provides that defense costs count towards the limit of liability. For this same reason, we

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[6] For example, in *Planet Ins. Co. v. Mead Reinsurance Corp., supra,* 789 F.2d 668, the insurer committed to indemnify the insured municipality for "Ultimate Net Loss" not exceeding the policy limits. The policy defined "Ultimate Net Loss" as "(1) The sum actually paid . . . in the settlement or satisfaction of losses . . . , (2) and includes attorney's fees, court costs and interest on any judgment or award. . . . " Interpreting the clause as a whole, the court concluded that attorney fees meant fees paid to a third party claimant and, thus, defense fees were not subsumed within the liability limits. (*Id.*, at pp. 671-672.) In contract, National Union's policy defines loss as including "costs, charges and expenses . . . incurred *in the defense* of actions" including "attorney's fees." (Italics added.)

And in *Grunewald & Adams v. Lloyds of London, supra,* 700 P.2d 888 the policy in question applied its liability limits to claims, including "costs and expenses incurred in connection therewith . . . by or on behalf of the Assured"; it also gave the insurer the right to take over and conduct the litigation. The reviewing court held that these provisions reasonably permit the interpretation that defense costs are incurred on the insurer's own behalf and in its self-interest. (*Id.*, at p. 890.) Again, this policy explicitly includes defense costs in the liability limits. This is in keeping with the insurer's limited defense role – one of giving reasonable consent to incurring such costs and to contesting a legal proceeding, and mutually agreeing to selection of counsel.

Similarly, in *Hertzka & Knowles v. Salter, supra,* 6 Cal.App.3d at page 326, the policy defined the "measure of loss" – to which the policy limits applied – as the "amount as may be assessed against the assured either by arbitration, adjudication, or as the result of a lawsuit, together with all costs or expenses incurred in connection therewith. . . . " The insurer, in settling with the insured, tried to deduct costs and expenses incurred on its own behalf *after* rejecting (with the insured's knowledge and without objection) a settlement offer that was within the policy limits.

need not delve into plaintiffs' arguments concerning the reasonable expectations of the insureds. (*Lumbermens Mut. Cas. Co. v. Vaughn* (1988) 199 Cal.App.3d 171, 179 [244 Cal.Rptr. 567]: "It is settled in this state that 'the doctrine of reasonable expectation of coverage comes into play *only* where there is an ambiguity in the policy.' ")

III. First Year Claims

National Union next attacks the trial court ruling that $10 million was available under the policy for first year claims. Its argument is threefold: There were no claims made in the first year because (1) no investor demanded money or services on account of a wrongful act; (2) no investor asserted liability against an individual officer or director; and (3) no one gave notice to National Union of any claim.

A. *Findings and Judgment Below*

The trial court referred the factual issue of first year claims to a special master who heard testimony from 24 investors. Each testified that he or she attempted to liquidate an investment during the first policy year. Typically,

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The Court of Appeal determined that the policy was reasonably open to the interpretation that the measure of loss only included costs or expense in connection with proceedings taken by, or on behalf of, the insured. Instead, the insurer rejected arbitration and then assumed exclusive control over the arbitration, which resulted in greater liability to the insureds. (*Id.*, at pp. 333-334.)

the investor contacted the officer[7] familiar with the account and instructed that officer to liquidate. Typically, the investors had been assured by an officer of the company that their investments were liquid and could be cashed out easily. In some cases the investors wanted to liquidate for personal reasons; many were displeased with the company and/or the performance of the particular security. Repeated attempts were made to move the officer to liquidate. In a few cases the investor obtained partial liquidation but in most cases none.

The special master concluded that there was sufficient evidence "to support a finding of liability for claims made during the first policy year." His "tentative decision" was incorporated into the final judgment. That decision states in part: "Each first year claimant was dissatisfied in some manner with the performance of his or her Technical Equities investment. This dissatisfaction led in turn to a claim made against one or more of the insured T.E. officers. Subsequent events have shown that poor performance of T.E. investments during the first policy year was the result of acts and omissions of the insureds. The causal connection between their wrongful acts and the claims is clear. [¶] [T]he first year claimants 'did not threaten suit, suspect or accuse an officer of misconduct or otherwise allege wrongdoing.' . . . A statement of wrongdoing by a claimant is not however a prerequisite for coverage. [¶] Although the policy may

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[7] In one case the investor dealt with an officer's secretary because the officer would not return telephone calls. In two or three other cases, the investors dealt with an account representative who was not an officer or director.

require a causative connection between wrongful acts and a claim, the ability of the claimant to articulate such a connection is not essential. To expect a claimant to do so would be unrealistic, especially in a complex situation such as existed here. . . . Requiring a claimant to identify the insured's wrongful acts at the time of the claim would serve no purpose other than tending to defeat coverage in most of the cases for which these policies are written. The court rejects such an interpretation of the policy."

B. *"Claims Made" Policy*

The National Union policy is a "claims made" policy,[8] identified as such on the declarations page. The insuring clause specifically commits National Union to pay (1) *against loss,* (2) *arising from any claim* or claims *first made against the insureds during the policy period,* and (3) by reason of any *wrongful act* in their capacities as officers or directors.

The parties strongly disagree on whether there is substantial evidence to support the finding that claims were made against directors and officers during the first

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[8] The difference between "claims-made" and "occurrence" policies has to do with the insured risk. Under a "claims-made" policy, the insurer generally is responsible for loss resulting from claims made during the policy period no matter when the liability-generating event took place. Under an "occurrence" policy, the insurer generally is responsible for loss resulting from acts that occur during the policy period, even if the claim is made after the policy expires. (See *Burns v. International Ins. Co.* (9th Cir. 1991) 929 F.2d 1422, 1424, fn. 3 and *Merrill & Seeley, Inc. v. Admiral Ins. Co.* (1990) 225 Cal.App.3d 624, 628 [275 Cal.Rptr. 280].)

policy year. We need not resolve this conflict because we agree with National Union that there can be no compensable first year claims absent notice thereof by the insureds or the company in that year. No one – not the company, the directors or officers, or the investors – reported a claim to National Union during the first policy year.

C. *Notice*

Clause 7(a) of the policy, captioned "Loss Provisions," states: "The time when a loss shall be incurred within the meaning of this policy shall be the date on which the Company . . . or the Insureds shall give written notice to the Insurer as hereafter provided." It further provides that as a condition precedent to the insureds' right to be indemnified, the company or the insured must "give to the Insurer notice as soon as practicable in writing of claims made upon the Insureds." Finally, the declarations page and limit of liability clause set National Union's maximum liability for any claim or claims at $10 million each policy year.

From these provisions, National Union asserts there is no insured loss until notice is given and, thus, whether there is coverage in any one policy year depends upon when or if that notice is given.[9]

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[9] The trial court concluded that "Under the law a claim is 'made' when it is made to the insured, TE, not when notice is given to the insurance company," citing *Phoenix Ins. Co. v. Sukut Construction Co.* (1982) 136 Cal.App.3d 673 [186 Cal.Rptr. 513]. *Phoenix* does so *assume*, but there is absolutely no indication that the policy in *Phoenix* contained loss or notice provisions similar to the ones involved here. A case which does not even discuss or quote the operative provisions is not precedent for subsequent judicial interpretation of language in another insurance policy.

Plaintiffs counter that nowhere does the policy say that the insureds must give notice to National Union during a policy year in order for coverage to apply for that year. They insist the policy language does not shed light on the importance of the timing of when a loss is incurred, nor does it link that time with the $10 million limit of liability per policy year or explain the significance of that limit. They point out that the insuring clause provides coverage for losses arising from claims *made during the policy period against the insured,* not for claims reported to the insurer during the policy period, although written notification at some unspecified point in time is a condition precedent to indemnification.

The policy is not crystal clear, and plaintiffs are right that it does not expressly state what National Union contends it means, namely, that there is $10 million of coverage per policy year for claims made against the insured *and reported* to the insurer. The surface lack of clarity lies in the fact that the insuring clause defines National Union's liability in terms of loss (the insurer must pay *"against loss"* arising from claims "made *during the policy period"*), whereas the limit of liability endorsement is phrased in terms of maximum liability *in a policy year* for *claims* made against it. Tacked on in clause 7 is the concept that loss is incurred upon notice to National Union.

Nonetheless, the policy, taken as a whole, is not ambiguous. First, we have already explained that the policy definition of "loss" directly links covered losses to claims. Therefore, the annual limits of liability apply to losses arising from claims. Second, since under the policy National Union is only liable for "losses," what matters

for purposes of tapping into that annual limit of liability is when a loss occurs. Clause 7(a) tells us that losses occur on the date the company or insured gives written notice to National Union of a claim. Third, the insuring clause itself which establishes National Union's responsibility to pay against loss is subject to all the conditions of the policy, including the clause 7 "loss provisions" and the annual limits of liability. There would be no purpose in tying loss to the timing of notice of a claim and, thus, no purpose to clause 7(a), if it did not function to allocate losses from claims against the annual limit of liability. Our Civil Code section 1641 states it well: "The whole of a contract is to be taken together, *so as to give effect to every part,* if reasonably practicable, each clause helping to interpret the other." (Italics added.)

D. *Notice-prejudice Rule*

Plaintiffs also invoke California's "notice-prejudice" rule, arguing that in order to avoid coverage on notice grounds, National Union must (but did not) demonstrate actual and substantial prejudice arising from delay in receipt of notice. The notice-prejudice rule operates to prevent an insurance company from denying coverage based on a breach of the policy's notice requirements unless the insurance company shows actual prejudice from the delay. (See *Campbell v. Allstate Ins. Co.* (1963) 60 Cal.2d 303, 306 [32 Cal.Rptr. 827, 384 L.Ed.2d 155].) This rule developed in the context of "occurrence" policies such as the automobile liability policy at issue in *Campbell.* (See *Pacific Employers Ins. Co. v. Superior Court* (1990) 221 Cal.App.3d 1348, 1357 [270 Cal.Rptr. 779] and cases cited therein.)

California courts are of two minds as to whether the "notice-prejudice" rule applies to claims made policies. In 1970, this district said it did, relying on *Campbell* and refusing to analytically distinguish occurrence from claims made policies. (*Northwestern Title Security Co. v. Flack* (1970) 6 Cal.App.3d 134, 143-144 [85 Cal.Rptr. 693].) More recently, a federal district court has followed suit, also applying *Campbell* and the notice-prejudice rule to a claims made policy without analysis. (*Mt. Hawley Ins. v. Federal Sav. & Loan Ins. Corp.* (C.D.Cal. 1987) 695 F.Supp. 469.)

Flack and *Mt. Hawley* do not concern the interplay between notice and *coverage,* and do not disucss the notice-prejudice rule in terms of the special features of a claims made policy or the type of policy language at issue here. Rather they deal with whether the insurer can *defend* on the basis of breach of the notice provisions.

The court in *Pacific Employers Ins. Co. v. Superior Court, supra,* 221 Cal.App.3d 1348, saw the distinction between "occurrence" and "claims made" policies as critical to evaluating whether to apply the notice-prejudice rule. (At p. 1357.) As it explained, in classic occurrence policies, coverage attaches when the occurrence takes place even though a claim is lodged at a later time. Notice provisions in these policies serve to aid the insurer in investigating, settling and defending claims, not as a definition of coverage. (*Id.*, at p. 1358.) The court went on to hold that applying the notice-prejudice rule to the claims made policy at hand – which covered claims made and reported during the policy period – would improperly convert that policy into an occurrence policy. In such policies, coverage itself depends on reporting the claim to

the insurer during the policy period. To allow a reporting extension beyond the policy period would be to rewrite the policy with an extension of coverage at no extra cost to the insured. (*Id.*, at pp. 1358-1359; accord, *Slater v. Lawyers' Mutual Ins. Co.* (1991) 227 Cal.App.3d 1415, 1421-1423 [278 Cal.Rptr. 479]; *Burns v. International Ins. Co., supra*, 929 F.2d at p. 1425 [expressing the belief that the California Supreme Court would not apply the notice-prejudice rule to claims made policies].)

Plaintiffs characterize the policies in *Slater* and *Pacific Employers* as "claims made and reported" policies, as contrasted with a pure "claims made" variety which they contend accurately reflects the National Union D&O policy. Whatever label one wishes to use, we have resolved that this policy contains a reporting element essential to coverage because, according to its terms, a loss, which triggers coverage, does not occur until notice of the underlying claim is given.

In any event, we line up with the reasoning expressed by the courts in *Pacific Employers* and *Slater*. Clause 7(a) makes notice an element of coverage; the issue is not one of failure to give timely notice. Subjecting this policy to the notice-prejudice rule would materially alter the insurer's risk. The hallmark of a "claims made" policy is that exposure for claims terminates with expiration or termination of the policy, thereby providing certainty in gauging potential liability which in turn leads to more accurate calculation of reserves and premiums. The benefit to the insureds is that the insurer can make coverage more available and cheaper than occurrence policies. (See *Pacific Employers Ins. Co. v. Superior Court, supra*, 221 Cal.App.3d at pp. 1359-1360.)

E. *Coverage for Potential Claims*

Under National Union's policy, coverage also extends to actual claims arising from potential claims which are reported to the insurer during the policy period.[10] Clause 7(c) assures a "tail" of coverage for situations that have not yet ripened into claims against directors and officers during the policy period but which the insureds expect will develop into full-blown claims down the road. National Union concedes that it received comprehensive notice in the second policy year which satisfies the reporting requirements of paragraph 7(c) and which advised it of all occurrences which might give rise to claims.[11]

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[10] In particular, paragraph 7(c) provides: "If during the policy period . . . [¶] (i) the Company . . . or the Insureds shall receive written or oral notice from any third party that it is the intention of such third party to hold the Insureds responsible for the results of any specified Wrongful Act by the Insureds while acting in the capacities aforementioned; or [¶] (ii) The Company . . . or the Insureds shall become aware of any occurrence which may subsequently give rise to a claim being made against the Insureds in respect of any such Wrongful Act; and [¶] shall in either case, during such period give written notice to the Insurer of the receipt of such written or oral notice under (i) above or such occurrence under (ii) above, then any claim which may subsequently be made against the Insureds arising out of such Wrongful Act shall for the purpose of this policy be treated as a claim made during the currency hereof."

[11] Specifically, on January 30, 1986, Senior Vice-President Craig Foster advised National Union by letter that in the wake of certain disclosures set forth in a press release issued the previous week, Technical Equities received "many phone calls from disgruntled investors" and "some [may] have consulted counsel." The letter goes on to state: "We are not aware of any lawsuits that have been filed at the present time. However, we

Plaintiffs maintain that by classifying subsequent, actual claims arising from a reported occurrence as claims "made during the currency" of the policy period – rather than during the policy year in which notice was given – clause 7(c) eliminates the concept of distinct policy years and the attendant limit of liability per policy year. In its place steps the broader concept of the policy period. Under their analysis, the second year notice of potential claims converts the annual limit of liability into an aggregate $30 million in coverage for the three-year period and, thus, it becomes irrelevant whether *actual* claims were made in the first year. They remind us that Technical Equities prepaid a three-year premium of $30,290 for coverage during the three-year policy period and that the insuring clause guarantees coverage against loss "arising from any claim or claims which are first made against the Insureds . . . *during the policy period*. . . . " (Italics added.)

Plaintiffs highlight as supporting their position the only reported decision discussing National Union's clause 7(c) language – *National Union Fire Ins. Co. v. Ambassador Group* (E.D.N.Y. 1988) 691 F.Supp. 618. The question in *Ambassador Group* was how much should National Union interplead to resolve multiple claims asserted against directors and officers covered by a three-year policy with liability limits of $3 million each policy year. National Union received notice of claims in both the

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want to give you notice of this occurrence because it may give rise to claims being made against this company, its subsidiaries, officers and directors under the policy of directors' and officers' liability insurance issued by National Union to Technical Equities."

first and second policy years. It characterized the first year notice as alerting it to " 'a wide range of alleged wrongful conduct by directors and officers of Ambassador Group . . . which caused [the company's] demise . . . " and insisted that all second year claims related back to this notice. (*Id.*, at pp. 621-623.) From this National Union apparently argued that it could limit its liability for subsequent claims to the limit of liability for the first policy year when it received in-depth notice of alleged wrongdoing.

The court in *Ambassador Group* rejected National Union's contention that clause 7(c) restricted its liability to $3 million for one policy year rather than the $6 million plaintiffs claimed was available. It explained: "This paragraph thus provides for certain limited instances in which a claim that is subsequently made will relate back to prior notice of an occurrence. If the Company becomes aware of and gives the Insurer written notice of an occurrence that may give rise to a claim, then any claim subsequently made 'will be treated as a claim made during the *currency hereof*' (italics added). Significantly, this provision does not indicate that the claim will relate back to the specific policy year during which notice of an occurrence was given, but, rather, more generally provides that the subsequent claim will be treated as a claim made during the currency of the policy. Thus, the provision appears to be designed to protect the insureds. If they notify the insurer of an occurrence that may give rise to a claim, and the claim is not actually asserted until after the Policy expires, then the claim will relate back to the 'currency' of the Policy. [¶] The construction that National Union attempts to give this provision is strained

and inconsistent with the plain terms of the Policy. . . . [Its] interpretation, taken to an extreme, would effectively permit National Union to limit its maximum aggregate liability to three million dollars rather than the nine million dollars provided for in the Policy." (*Ambassador Group, supra*, 691 F.Supp. at p. 623.)

Plaintiffs charge that clause 7(c) at best is ambiguous because it leaves open the question of how to allocate claims made after a notice of occurrence, echoing the *Ambassador Group* court. ("The language in paragraph 7(c), however, is at best ambiguous. In such a situation, it is axiomatic that the Policy is to be construed against the insurer." [*Ambassador Group, supra*, 691 F.Supp. at p. 623.].) Plaintiffs are right that 7(c) does not tell us how to allocate subsequent claims. However, they seem to forget that clause 7(a) tells us that *all losses* under the policy are incurred on the date notice is given. This is a *general* loss provision which, by referring to the giving of written notice "as hereinafter provided," encompasses both the notice of claims (clause 7(b)) *and* the notice of occurrences (clause 7(c)). Plaintiffs' argument and the decision in *Ambassador Group* completely ignore the effect and meaning of clause 7(a).

Note, however, that we do not agree with the use to which National Union wishes to put this clause, namely, that all losses stemming from actual second *and third year* claims would be funneled into the second policy year because that is when Technical Equities gave comprehensive notice of occurrences. Thus, National Union asserts there is no third year coverage because the second year

report attributes all subsequent claims and losses to that year.[12]

National Union loses this argument because it imposes a hierarchy on the notice provisions that defeats coverage. Clause 7 details the notice requirements for actual and potential claims. We have both in this case – second year notice of potential claims, and second (and third year)[13] notice of actual claims.

Is the notice of occurrence provision superior to the notice of claim provision? Clause 7(a) tells us to attribute loss to the date of notice, but does not tell us how to resolve competition between the two types of notice. We must resolve this ambiguity in favor of the insureds. Therefore, we conclude the concept of subsequent claims

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[12] National Union also attempts to bolster its position by referring us to the "interrelated acts" provision of clause 5(c) which states that "losses arising out of the same or interrelated acts of one or more of the Insureds shall be considered a single loss. . . . " The policy declarations, as amended, provide for a $5,000 retention per director or officer, subject to a maximum of $7,500 per loss. Clause 5(c) goes on to state that the $5,000 per director/officer retention applies separately to each such person for each loss and where the "per loss" maximum retention applies, that retention is to be prorated among the insureds in proportion to their respective losses. In context it is clear that the interrelated acts provision pertains solely to calculation of the retention amount to be borne by the insureds and not to the issue of when loss is incurred for purposes of applying the annual limit of liability for a particular policy year. The court in *Ambassador Group* arrived at the same conclusion when responding to a similar argument based on similar language. (*Ambassador Group, supra,* 691 F.Supp. at p. 622.)

[13] National Union has never argued that it did not receive notice of third year claims.

developed in clause 7(c) for all practical purposes refers only to claims made *after* the policy expires and, thus, this provision is inapplicable to claims made during the policy period. (*See Ambassador Group, supra,* 691 F.Supp. at p. 623 [framing its discussion of "subsequent claims" in terms of claims asserted after the policy expires].) This construction is in keeping with the purpose of a coverage tail, namely, to ensure that losses arising from certain claims made after the policy expires will be treated as covered losses under the policy. Moreover, if clause 7(c) were read as encompassing all claims made after a comprehensive occurrence notice – whether made before or after expiration of the policy – it would be meaningless and redundant. A claim made during the policy period *is* "made during the currency" of the policy period and there is no need to treat it specially.

Finally, National Union, trying to argue fairness and common sense, explains that by assigning all claims to the policy year in which notice of the occurrence was given, the policy limits of subsequent years are preserved for unrelated claims. Thus directors and officers who are vicariously liable or who are not involved in a reported occurrence are assured that their coverage will not be reduced or eliminated by the wrongful acts of other directors and officers who reported occurrences in a prior policy year. In certain limited situations this might be the case, depending on whether claims are actually made based on the reported occurrence, whether those claims are lodged before other directors and officers can lodge their claims, and whether those claims absorb all the coverage. The policy, however, simply does not attempt to establish a "per occurrence" cap on losses or otherwise

ration coverage among the various insured directors and officers. Needless to say, National Union's apparent concern about preserving coverage for other directors and officers is self-serving – the impact of its argument in this case is to eliminate an entire year of coverage – not to preserve it for someone else.

IV. Third Year Coverage

National Union finally protests the trial court's ruling on third year coverage. It advances several theories. We have already rejected the contention that all lawsuits filed in the third year are subsumed under the second year because they were preceded by a comprehensive notice of occurrences in that year. The remaining arguments center on the proposition that the policy was properly canceled in the bankruptcy proceeding before inception of the third policy year, therefore precluding any scrutiny here of the propriety or effect of cancellation.

A. *Factual Background*

The policy gives National Union the right to cancel upon 30 days' written notice to Technical Equities. The policy also directs the company to act on behalf of the insured directors and officers with respect to the giving and receipt of notice of cancellation.

In May 1986 – three months after Technical Equities filed for protection under the Bankruptcy Code – National Union gave written notice of cancellation effective the following month. At that time it also denied the existence of coverage for acts of officers and directors of

Technical Equities *as debtor in possession* (DIP). A dispute arose as to whether National Union could deny coverage to DIP officers and directors and whether cancellation would violate the automatic bankruptcy stay. At the June 10, 1986, meeting of the board of directors of Technical Equities, the board resolved "to negotiate with National Union . . . and accept a *continuation of the present officers' and directors' liability policy* for a period of at least 12 months at the coverage amount of $5,000,000 if no addition premiums need be paid." (Italics added.)

Counsel for National Union and Technical Equities then struck a deal whereby National Union would *cancel* the existing policy and issue a new policy covering post-bankruptcy acts of directors and officers of the DIP. National Union would also provide coverage for a period of extended discovery for prepetition acts as provided, upon election, under the original policy. The premiums for the new policy and for extended discovery would equal the unearned premium on the canceled policy.

Counsel for the two entities then moved for an order approving the compromise and served notice of the hearing to the directors and officers of Technical Equities (or their attorneys) and others.

On July 28, 1986, the Honorable Lloyd King of the United States Bankruptcy Court, Northern District of California, held a short hearing on the motion and two other Technical Equities matters. None of the directors or officers appeared personally or through counsel at this hearing. Counsel for Technical Equities briefly described the compromise and asked for the court's approval. The court asked about coverage for claims based on prepetition

conduct. Counsel explained that claims made until cancellation would be covered under the old policy and subsequent claims based on prepetition acts made within a year of cancellation would be covered under the extended discovery clause.[14] However counsel did *not* explain that under the policy, these postcancellation claims would be allocated to the liability limits for the second policy year. On August 5 the court filed its order approving the compromise.

Thereafter, National Union went to federal district court in an unsuccessful attempt to halt enforcement of any judgment that might be entered against it in this case and the coordinated bad faith actions. National Union claimed the bankruptcy order barred entry of any judgment against it for bad faith to the extent the judgment was predicated on coverage for the canceled policy period. The Ninth Circuit Court of Appeals summarily affirmed the district court's decision.

Judge Rushing in this action determined that the compromise was not binding on plaintiffs or the officers and directors. His ruling centered on the constitutional inadequacy of notice for the motion to approve the compromise. He also concluded that National Union's attempt to cancel the policy was "arbitrary and without legal justification." In the subsequent McLaughlin v. National Union bad faith action, the trial court instructed the jury: "Cancellation of the third year of the D&O policy was invalid, and had no effect on plaintiffs herein,

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[14] In fact, the discovery clause provided for six months extended coverage.

a bankruptcy order to the contrary notwithstanding." Prior to this appeal, National Union sought extraordinary relief here, to no avail. The Supreme Court denied review.

National Union launches a broad-based attack on the trial court's decision on third year coverage. Its opening assertion is that we should honor the "consenual" cancellation between itself and Technical Equities, DIP. It then argues that none of the injured investors have vested rights in the liability limits of the third policy year because the policy was canceled before any third year claims could be made and reported. Third, National Union maintains the present declaratory relief action is an impermissible collateral attack on the bankruptcy court order approving the compromise. Finally, it asserts that any party who received notice of the July 28 hearing, including any officer or director, could have challenged the compromise but did not. As to these people and their privies, including plaintiffs, National Union contends the bankruptcy order is res judicata. We take these arguments in order and conclude with an analysis of the plaintiffs' claim that National Union pursued cancellation in bad faith.

B. *"Consensual" Cancellation*

National Union first maintains that we should respect the "consensual" cancellation between itself and Technical Equities, DIP because it comported with all policy requisites. It reminds us that the policy gives the carrier and the insured company the mutual right to cancel – the company at any time by written notice or surrender of the policy, the carrier by 30-day written

notice. Since nowhere is notice to the directors and officers called for, National Union contends that should end this matter.

Not so. Compliance with contractual provisions governing cancellation does not seal the legal validity of National Union's actions in pursuing cancellation.

Notwithstanding National Union's argument to the contrary,[15] this lawsuit has raised the issue of whether National Union's conduct amounted to a breach of the covenant of good faith and fair dealing. This question has nothing to do with whether, as a private contractual matter, the former directors and officers were entitled to notice. Rather, it has everything to do with whether National Union acted in good faith as to the directors and officers. National Union tries to portray these two matters as coterminous and contradictory when they are not.

C. *Vested Rights*

National Union next urges that plaintiffs and other injured investors have no standing to question the order approving the compromise because they have no vested

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[15] National Union states: "Plaintiffs' contention that the cancellation was invalid because National union acted in bad faith . . . was never raised or tried or determined in this case." National Union must realize that the validity of its actions in pursuing cancellation was a pivotal issue below. In their pretrial statement, plaintiffs highlighted the undisputed and disputed facts going to this issue and briefed the matter in the trial court. Moreover, much of the evidence offered at trial went to this issue. Finally, National Union itself in its proposal on issues to be decided framed the question: "Was cancellation valid?"

rights in the policy's third year coverage. This is so, it argues, because the policy was canceled during the second year, before anyone could assert, let alone report, a claim which would tap the liability limits of the third policy year. National Union's argument is flawed. It is the directors and officers who have standing to raise the issue of third year coverage, the ultimate question being whether the compromise and cancellation cut off their rights to the liability proceeds for that policy year. If, as is the case, the answer is no, then the former directors and officers have $10 million in third year coverage which is available to pay for losses of third year claimants.

For purposes of standing to bring this declaratory relief action, plaintiffs have an "interest" in determination of the issue of third year coverage because they are direct assignees of a portion of the right, title and interest of certain former directors in the policy. (Code Civ.Proc., § 1060: "Any person interested . . . under a contract, or who desires a declaration of his rights or duties with respect to another . . . may, in cases of actual controversy relating to the legal rights and duties of the respective parties, bring an original action . . . for a declaration of his rights and duties in the premises. . . . ") The former officers and directors, in turn, were nominal defendants in this action. Many of them cross-complained against National Union seeking, among other relief, a declaration as to outside limits of the policy. They participated throughout the proceedings and it was efficient and proper for the court to declare the extent of coverage available to them under the policy, including the third policy year thereof.

D. *Collateral Attack*

The bankruptcy court order approving the compromise is final – no one appealed from it or brought a direct attack seeking relief from the order. National Union maintains that the instant declaratory relief action is an impermissible collateral attack on that order and an abuse of the principal of judicial comity.

We do not classify this lawsuit as a collateral attack on the bankruptcy order. Rather, plaintiffs are seeking a declaration that the insureds are entitled to the liability limits of the third policy year precisely because the bankruptcy order did not impact or determine rights as between the insurer and its insureds.[16]

Bankruptcy proceedings operate in rem (*Levy v. Cohen* (1977) 19 Cal.3d 165, 172 [137 Cal.Rptr. 162, 561 P.2d 252]) and, thus, orders rendered therein with respect to the debtor's property are conclusive upon the whole world (see *Gratiot County State Bank v. Johnson* (1919) 249 U.S. 246, 248 [63 L.Ed. 587, 588]). For the very reason that the compromise order was in rem, its scope necessarily was narrow, confined to the policy itself. While it may be that the policy belongs to Technical Equities and, thus, is part of the estate, the liability proceeds thereunder do not. This is because D&O policies do not provide coverage for claims against the corporation itself; they provide reimbursement to the corporation for its indemnification of individual officers and directors. The liability proceeds

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[16] Plaintiffs have argued that the bankruptcy order is void because it violated the automatic stay. The trial court did not decide this issue, nor do we.

belong directly to the officers and directors. (*In re Louisiana World Exposition, Inc.* (5th Cir. 1987) 832 F.2d 1391, 1399-1400.)

Therefore, while the results of the order were to approve a cancellation agreed upon between National Union and Technical Equities, DIP and set in place a new policy covering the directors and officers of the DIP, the order did not cut off or determine the preexisting rights of the former directors and officers to the policy proceeds, or alter the preexisting duties of National Union to its insureds. These right and duties have nothing to do with the debtor's property. The insureds had a preexisting right to third year coverage absent a good faith cancellation. If, as the trial court found, National Union did not act in good faith in seeking cancellation, it follows that the directors and officers remain entitled to the benefits of third year coverage.

Recently, the Ninth Circuit, in a somewhat similar situation, rejected the argument that a third party's declaratory relief suit was a collateral attack on a bankruptcy court order approving a settlement agreement between the debtor and its bank: "This argument much over-states what the order of the bankruptcy court did. The bankruptcy court authorized [the debtor] to settle with the Bank of America. It did not purport to determine the effect of the settlement on Teerlink's lots. . . . There was nothing in the agreement and a fortiori nothing in the order of the bankruptcy court that barred Teerlink from seeking the declaration the district court issued. . . . " (*In re Teerlink Ranch Ltd.* (9th Cir. 1989) 886 F.2d 1233, 1236.)

So, too, the bankruptcy court order here did not purport to determine the rights of the insured directors and officers under the policy. Thus we conclude that the real issue framed by this lawsuit is not whether it is an impermissible collateral attack on a final bankruptcy court order, but whether the doctrine of res judicata bars plaintiffs' efforts to raise the issue of National Union's bad faith.

E. *Res Judicata Analysis*

A judgment or order of a bankruptcy court, once rendered, is final for purposes of res judicata until reversed or modified on appeal or set aside in the rendering court. (*Levy v. Cohen, supra,* 19 Cal.3d at p. 172.) The doctrine of res judicata will prevent readjudication of all matters which were, or might have been, litigated in the earlier proceeding between the same parties. (*Chicot County Dist. v. Bank* (1940) 308 U.S. 371, 375 [84 L.Ed. 329, 333, 60 S.Ct. 317].) On the other hand, "an adjudication in bankruptcy, like other judgments in rem, is not res judicata as to the facts or as to the subsidiary questions of law on which it is based, except as between parties to the proceeding or privies thereto." (*Gratiot County State Bank v. Johnson, supra,* 249 U.S. at p. 248 [63 L.Ed. at p. 588].)

No one disputes that issues concerning the directors and officers rights to the third year policy proceeds, and National Union's corresponding obligations, were not litigated at the compromise hearing. Three issues are disputed: whether the directors and officers *could have*

litigated these matters; whether plaintiffs could have contested the compromise; and whether plaintiffs' interests were represented by others present at the hearing.

(1) *Directors & Officers*

Plaintiffs assert some claims against National Union as assignees of the directors and officers and, therefore, they are privies of the insureds. (See *Woolett v. American Employers Ins. Co.* (1978) 77 Cal.App.3d 619, 625 [143 Cal.Rptr. 799].) If the directors and officers are held to be parties to the compromise proceeding, then neither they, nor plaintiffs through them, can adjudicate the lawfulness of National Union's conduct here because they could have raised the issue in the earlier proceeding. National Union takes the position that the directors and officers were parties because the notice of motion was constitutionally adequate to alert them that their personal interests might be affected and, therefore, they should attend the hearing to object. True, the officers and directors technically are "parties" to the overall bankruptcy proceeding because they are creditors whose rights in the debtor's property will be conclusively determined therein. (See *Levy v. Cohen, supra*, 19 Cal.3d at p. 172.) However, as we explain, for purposes of res judicata analysis, they were not parties who could be held to have litigated *anything* in the compromise proceeding with respect to their personal rights to the third year policy proceeds because the notice of motion was not a notice that their personal interests were at stake.

The notice recited that: (1) The policy was for the period August 5, 1984, to August 5, 1987; (2) Technical

Equities "paid the entire premium due for the three years covered by the Policy, which contained a $10,000,000 liability limit, subject to specified terms and conditions"; (3)"The compromise set forth in the Motion is in the best interest of the estate and creditors"; (4) Technical Equities will agree that the policy is canceled effective July 13, 1986; (5) National Union will agree to issue a new policy covering acts of the officers and directors of Technical Equities, DIP arising after the bankruptcy and to provide one year extended discovery under the old policy; (6) the unearned premiums would be allocated to the cost of the new policy and the discovery tail; (7) "The complete terms of the compromise are set forth in the Motion. Copies of the Motion and the exhibits thereto, including the Policy . . . are on file with the court"; and (8) "Any interested party that objects to the Motion must file with the court . . . written notice of any objections . . . within ten (10) days after service of this notice."

National Union first calls attention to *Matter of Gregory* (9th Cir. 1983) 705 F.2d 1118 and other cases treating the issue of adequacy of notice in bankruptcy proceedings. *Gregory* concerned notice of a creditor's meeting and confirmation hearing. A copy of the debtor's plan was not included with the notice, and the notice itself was "not unambiguous." The plaintiff, holder of a large unsecured claim, did not attend the meeting and the plan was confirmed.

The court in *Gregory* held that when a creditor "receives any notice from the bankruptcy court that its debtor has initiated bankruptcy proceedings, it is under constructive or inquiry notice that its claim may be affected, and it ignores the proceedings to which the

notice refers at its peril. 'Whatever is notice enough to excite attention and put the party on his guard and call for inquiry, is notice of everything to which such inquiry may have led. When a person has sufficient information to lead him to a fact, he shall be deemed to be conversant of it.' [Citations]. . . . If Lawrence had made any inquiry following receipt of the notice, it would have discovered that it needed to act to protect its interest." (*Matter of Gregory, supra*, 705 F.2d at p. 1123.)

Similarly, a bankruptcy court recently explained that a notice under Federal Rules of Bankruptcy Procedure, rule 2002[17] is not intended or required to fully explain the circumstances of the case – a notice is a notice, not a case history, and details can be obtained by procuring copies of the underlying motion and agreement, as stated in the notice. (*In re Lee Holding Co.* (Bankr. S.D.Ohio 1990) 120 Bankr. 881, 889-890.)

Citing these and other cases, National Union asserts the directors and officers were on inquiry notice that their interests could be affected; the notice itself indicated that the motion and copies of the policy were on file with the court; had they made inquiry, they would have discovered the need to protect their interests.

Although *Gregory* contains broad language about inquiry notice from documents served in a bankruptcy case, the facts show an unsecured creditor claiming he did not realize he would receive zero payments under the debtor's chapter 13 plan when the actual notice said:

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[17] This rule governs notice on hearings on approval of a compromise or settlement, among other matters.

" 'The debtors' plan does not propose payment of unsecured creditors.' " (*Matter of Gregory, supra*, 705 F.2d at p. 1120.) In this context, the court's reasoning suggests that the creditor should not have withheld action on the belief that this statement was ambiguous – checking the file, with the actual plan, was in order rather than holding out hope that he would be paid.

Moreover, *Gregory* concerned the initial meeting of creditors and the confirmation hearing on the debtor's plan, the heart of proceedings involving an individual debtor. The notice was the first notice any creditor would personally receive that its debtor had initiated bankruptcy proceedings; whatever plan that was confirmed would bind the debtor and each creditor. (11 U.S.C. § 1327 (a).) The confirmation hearing affords any party in interest the opportunity to object to confirmation of the plan. (11 U.S.C. § 1324.) How else would the creditor protect his or her unsecured claim but by attending the creditor's meeting and confirmation hearing? Even if the order said nothing about payment of unsecured creditors, under these circumstances the creditor is on inquiry notice that his or her claim is potentially impaired.

In contrast, the hearing on the compromise, although a "core" proceeding, was not a required pivotal event in chapter 11 proceedings. Indeed, the agreement itself was described as a compromise *solely* between Technical Equities and National Union. Further, the notice talked about a $10 million liability limit, which suggests a single policy amount, not the potential of three annual limits. Third, there was no hint or suggestion that cancellation could eradicate $10 million in coverage for claims made during

the third year based on prepetition acts of officers and directors.[18] Rather, the overall import was that there would be no gaps in coverage because the "one year" extended discovery period would kick in after cancellation, and the successor DIP policy would cover acts occurring thereafter.[19] Fourth, the notice was addressed to "all interested parties" with no specific targeting of the only individuals who National Union now argues were directly impacted by cancellation. Fifth, written objections were to be filed in a short period of time – 10 days from service of notice (even bankruptcy rule 2002 calls for 20 days' notice unless notice is dispensed for cause). Judge Rushing concluded for all these reasons that the notice was constitutionally inadequate to alert the directors and officers that their direct interests as insureds

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[18] Significantly, Judge King, who approved the compromise, consistently indicated in subsequent rulings that he did not intend the compromise to affect matters of coverage or policy limits – those issues were left to the state court. Moreover, at the initial hearing on the compromise, Judge King inquired as to coverage for claims based on prepetion conduct. Counsel for Technical Equities represented that the compromise transaction was designed so that there would be no coverage gaps – claims made up to termination of the policy would be covered under that policy; the new policy would pick up post-petition acts, and the discovery tail would cover claims based on prepetition acts made subsequent to cancellation. Nothing was said to indicate that coverage would be diminished by one-third based on the cancellation!

[19] Of course, as National Union points out, had the directors and officers procured a copy of the policy and put a microscope to it, they may have figured out that claims reported under the discovery tail would be attributed to the second policy year's liability limits.

might be at stake to the tune of sacrificing $10 million of third year coverage. In a practical sense there was *no notice* that anyone was challenging or otherwise attempting to adjudicate the rights of officers and directors as insureds under the policy vis-á-vis their insurer. Therefore, these are not matters that "could have been" litigated at the compromise hearing. (*Chicot County Dist. v. Bank, supra,* 308 U.S. at p. 375 [84 L.Ed. at p. 333].)

We note that it is the practical effect of notice that carries constitutional significance. When the action involves possible deprivation of an individual's property rights, due process requires that "The notice must be of such nature as reasonably to convey the required information, [citation], and it must afford a reasonable time for those interested to make their appearance. . . ." (*Mullane v. Central Hanover Tr. Co.* (1950) 339 U.S. 306, 314 [94 L.Ed. 865, 873, 70 S.Ct. 652].) While the problem in *Mullane* was the inadequacy of notice by publication, the ramifications are broader, the mandate being to evaluate whether, "under all the circumstances" notice meets the constitutional reasonableness standard. National Union attempts to construe the notice here as signalling that the directors and officers should appear and protect their individual rights against their insurer. So construed, the notice fails the constitutional standards. As a notice intended to alert creditors in general about the disposition of premium refunds and the insurance status of the DIP – the only legitimate matters that concern the debtor's property and that could possibly interest a creditor *qua* creditor – the notice was adequate.

(2) *Status as Unsecured Creditors*

In their bad faith action against National Union, plaintiffs also pursue some claims directly against the insurer rather than as assignees of the insured directors and officers. National Union reasons that the order approving cancellation is res judicata even as to plaintiffs when they don their own hats because, as unsecured creditors of Technical Equities, they were parties to the bankruptcy proceedings and are deemed bound by the resulting orders. (Citing *Levy v. Cohen, supra,* 19 Cal.3d at p. 172 and *MacArthur Co. v. Johns-Manville Corp.* (2d Cir. 1988) 837 F.2d 89.) What it forgets to mention is that the plaintiff in *Levy* had notice of the operative proceeding and an opportunity to litigate his concerns – therefore, the order was conclusive as to him. So, too, the distributor in *MacArthur Co.* received notice before the bankruptcy court approved the settlements in question. Our plaintiffs of course received no notice of *any* bankruptcy proceeding, did not attend the hearing, and were not parties to the compromise agreement itself.

More importantly, while plaintiffs may have claims against Technical Equities in the abstract, the record does not reveal that they have identified themselves as creditors of the company. We find nothing indicating they have filed proofs of claim or otherwise asserted their interests in the bankruptcy proceedings. Instead, they have pursued actions against the negligent corporate officers and directors. Thus, there is no substantial identity of interest between plaintiffs as injured investors and the unsecured creditors who are pursuing and perfecting a

claim against the corporation. As to self-identified creditors of the corporation, the compromise would make sense because it favored the debtor's continued existence.

(3) *Privity with Others*

Finally, National Union urges that res judicata bars plaintiffs' present suit because they were in privity with others who were parties to the compromise proceeding. "A non-party is in privity with a party for res judicata purposes in three instances. First, if he has succeeded to the party's interest in property. . . . Second, if he controlled the prior litigation. . . . Third, . . . if the party adequately represented his interests in the prior proceeding." (*Latham v. Wells Fargo Bank, N.A.* (5th Cir. 1990) 896 F.2d 979, 983). The California rule is similar: Privity exists where the nonparty has an identity of interest with, and adequate representation by, the party in the first action and the nonparty should reasonably expect to be bound by the prior adjudication. (*Frazier v. City of Richmond* (1986) 184 Cal.App.3d 1491 [228 Cal.Rptr. 376].) The broadest theory of nonparty preclusion is that of "virtual representation." This doctrine posits that a person not a party to a prior action nonetheless is bound if his or her interests are so similar to a party's interest that the latter was the former's virtual representative in the earlier action. (*United States v. Geophysical Corp.* (9th Cir. 1984) 732 F.2d 693, 697.)

National Union asserts that plaintiffs were virtually represented by at least four separate parties: the trustee

in bankruptcy; counsel for the unsecured creditors' committee; counsel for an uncertified federal class of plaintiffs; and a corporate investor.

What role did these parties play in the compromise? The trustee was not present at the hearing, nor was the motion to approve the compromise spearheaded by the trustee as normally would be the case.[20] The corporate investor was not present, nor is there any indication that this investor was formally acting in a representative capacity. Counsel for the unsecured creditors' committee and for certain federal class action plaintiffs attended the continued hearing on Technical Equities matters, but participated solely in a subhearing on an entirely different issue. Counsel for the unsecured creditors' committee, however, did approve the form of the order.

As noted above, there was no substantial identity of interest between plaintiffs and the unsecured creditors' committee. The same could be said for the plaintiffs and the trustee, who is the creditors' representative. (*Matter of Met-L-Wood Corp.* (7th Cir. 1988) 861 F.2d 1012, 1017.) While there may be an identity of interest between plaintiffs and the corporate investor and the uncertified federal class, the former did not attend and the latter did not come forward during the portion of the hearing dealing with the compromise.

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[20] Federal Rules of Bankruptcy Procedure, rule 9019(a) provides: "*On motion by the trustee* and after a hearing on notice to creditors [and others] as provided in Rule 2002 . . . , the court may approve a compromise or settlement." (Italics added.)

In the federal cases concerning privity and virtual representation in the context of a prior bankruptcy proceeding, the party deemed to be a virtual representative of the nonparty was the prime mover and a vigorous participant in the earlier proceeding. (See *In re Medomak Canning* (1st Cir. 1990) 922 F.2d 895; *Matter of Met-L-Wood Corp., supra,* 861 F.2d 1012.) Indeed, *adequate* representation in the earlier litigation by the party with parallel interests in the pivotal requirement for virtual representation. (18 Wright et al., Federal Practice and Procedure (1981) Jurisdiction and Related Matters, § 4457, pp. 494-502; *id.*, (1992 supp.) § 4457, at pp. 311-320 and cases cited therein.)

Here the settlement was between National Union and Technical Equities and none of the creditors (or the trustee) actually participated in negotiations or the hearing although by virtue of the notice they were afforded an opportunity to object.

National Union claims this lack of participation is irrelevant because these parties had the opportunity to object. However, it cites no authority for the extreme proposition that a nonparty can be bound by a judgment in an earlier proceeding of which he or she did not have notice and notwithstanding that there was virtually no advocacy, no control, and no actual participation in the litigation by the party with "identical" interests. For example, in *Medomak Canning,* where the reviewing court applied the virtual representation concept to junior lienholders on grounds of adequate representation by the trustee in bankruptcy, the trustee had spearheaded the previous compromise proceeding *plus* the lienholders had

adequate notice of the hearing to approve the compromise.

In conclusion, for all the reasons aired above, we determine that the bankruptcy court order is not res judicata to the present adjudication of the issue of third year coverage.

F. *The Cancellation Violated the Covenant*

Liability carriers do not have an unfettered right to cancel coverage, notwithstanding mutual cancellation clauses to that effect. Cancellation provisions in an insurance contract are subject to the implied covenant of good faith and fair dealing just like any other clause. (*Spindle v. Travelers Ins. Companies* (1977) 66 Cal.App.3d 951, 958 [136 Cal.Rptr. 404].) This is a covenant " ' . . . that neither party will do anything which will injure the right of the other to receive the benefits of the agreement.' " (*Gruenberg v. Aetna Ins. Co.* (1973) 9 Cal.3d 566, 573 [108 Cal.Rptr. 480, 510 P.2d 1032].) The phrase "good faith" in the context of performance or enforcement of a contract " 'emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party. . . . ' " (*Neal v. Farmers Ins. Exchange* (1978) 21 Cal.3d 910, 921-922, fn. 5 [148 Cal.Rptr. 389, 582 P.2d 980], quoting Rest.2d Contracts (Tent. Draft Nos. 1-7) § 231, com. a.) The precise duty embraced by the covenant depends on the nature of the bargain struck between the insurer and the insured and the legitimate expectations of the parties arising from the contract. (*Commercial Union Assurance Companies v. Safeway Stores, Inc.* (1980) 26 Cal.3d 912, 918 [164 Cal.Rptr. 709, 610 P.2d 1038].)

For our purposes the cancellation clause in *Spindle* was identical to the one at issue here. Plaintiff alleged the insurer cancelled for the purpose of making "an example" of him so as to discourage other insureds from resisting a 140 percent premium increase. He also alleged that insurance was not available at competitive rates from solvent, nonhazardous insurance carriers. The reviewing court found that this purported reason rendered cancellation a violation of the covenant. (*Commercial Union Assurance Companies, supra,* 26 Cal.3d at pp. 918-919.)

Plaintiffs claim National Union's purported cancellation of third year coverage for the directors and officers breached the covenant of good faith and fair dealing. They contend its purpose was to avoid paying $10 million in coverage on third year claims – coverage which the insureds bargained for and could reasonably expect to remain intact. They recite the following facts: National Union had notice of potential claims, knew Technical Equities had filed under chapter 11, and knew that substantial claims had been made against its insureds. As early as February 12, 1986, interoffice memoranda referred to "The Problem" and "Big Problems."

In March 1986 Christopher Cavallaro, National Union's senior vice-president in charge of underwriting D&O insurance, made the decision to cancel Technical Equities' policy. He knew Technical Equities was in chapter 11 and had prepaid its premiums on the three-year policy. He was also aware that there were significant lawsuits pending against the directors and officers and more were expected to be filed. He based his decision to cancel on information related to him by Attorney Ken Sagat of D'Amato & Lynch which gave him a "gut

feel[ing]" that some individuals at Technical Equities were "guilty of gross fraud." His understanding concerned three to five officers; he was not aware of any information indicating that the outside directors were engaged in gross fraud. Cavallaro's stated reason for cancelling was that he did not want to do business with people guilty of gross fraud. However, he also indicated that the policy did not afford coverage for dishonest acts established by adjudication. Nonetheless, he still felt a need to cancel the policy because they "weren't sure where the corporation was going" and "what was going to occur going forward."

Cavallaro did not know how Sagat came upon his information, nor did he attempt to verify its accuracy. He did not obtain input from anyone else within National Union's underwriting department, or elsewhere within or outside the company; he did not communicate with the insureds or their attorneys; he did not review any written material to apprise himself of the situation. In short, National Union did not undertake any investigation.

Cavallaro testified in court that he had no personal knowledge of fraud at Technical Equities until 1989 when he saw judgments in the coordinated action. His decision to cancel was informed only by allegations of fraud; he did not "think" anybody was guilty of anything, he "thought" there were some allegations. Cavallaro also expressed that fraud is alleged in "just about every D and O case. . . . " This was the only National Union cancellation he knew of where the premium had been prepaid and the company had filed for bankruptcy.

Cavallaro's reason for cancelling was not communicated to anyone involved in or affected by the cancellation, including National Union's own staff, Technical Equities, the insured directors and officers, and the insurance broker.[21] The senior underwriter for National Union indicated that in 1986 National Union did not have any policy guidelines concerning the basis for cancelling D&O policies. Technical Equities was the only cancellation he was aware of since joining National Union in 1983. It was also the only one that National Union's underwriting manager was aware of involving a corporation which had filed for bankruptcy.

Plaintiffs asserted below and reiterate here that National Union put its own interests ahead of its insureds, cancelling the policy to avoid paying up to an additional $10 million in third year claims, at the time when the directors and officers most needed the protection that had already been paid for.

The court found that "the attempted cancellation was arbitrary and without legal justification."[22] This finding is

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[21] Under recent additions to the Insurance Code, commercial liability carriers are now required to state the reason for cancellation in the notice. (Ins. Code, § 677.2, added Stats. 1986, ch. 1321, § 5.) Cancellation is not effective unless it is based on one of the enumerated statutory grounds. (Ins. Code, § 676.2, subd. (b).)

[22] Dubbing this a finding that National Union lacked good cause, National Union states it was entitled to cancel the policy without cause, citing *Jensen v. Traders & General Ins. Co.* (1959) 52 Cal.2d 786, 790 [345 P.2d 1] and *Beavers v. Allstate Ins. Co.* (1990) 225 Cal.App.3d 310, 318 [274 Cal.Rptr. 766]. While *Jensen* did determine that a standard cancellation clause giving five days'

supported by the evidence reviewed above. The attempted cancellation was arbitrary because it was based on mere allegations of fraud that were not tested by any verification.[23] Moreover, as Cavallaro the decisionmaker put it, nearly *all* D&O claims are accompanied by allegations of fraud. Yet this was the only cancellation he could remember involving a bankrupt, prepaid company. Further, the purported cancellation was across the board, sweeping aside numerous officers and directors which Cavallaro could not associate with allegations of gross misconduct. This, when loss reasonably foreseeable at the policy's inception, is imminent and unavoidable on the part of the prepaid insured at the time of cancellation. (See *Home Ins. Co. of New York v. Heck* (1872) 65 Ill. 111, 114, stating a similar concept in light of extreme facts, namely, insurer gives notice of cancellation when fire is approaching the insured property: "Of what avail would it be, to take a policy against fire, to permit its cancellation when the fire is approaching?") National Union's

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notice did not violate public policy, it did not concern the applicability of the good faith covenant to cancellation provisions nor did it review a factual determination of breach. *Beavers* relies exclusively on *Jensen*, and although there was an evidentiary issue concerning the covenant, that portion of the opinion was not published.

[23] We note that under the new statutory restrictions on cancellation, an allowable reason to cancel is "*[d]iscovery of* willful or grossly negligent acts or omissions . . . by the named insured . . . which materially increase any of the risks insured against." (Ins. Code, § 676.2, subd. (b)(4).) We emphasize the phrase "discovery of" because it connotes what did not happen here, namely, that awareness of the act or omission was the result of a search or inquiry.

willingness to help Technical Equities, DIP, by issuing a new, one-year, $5 million policy in favor of DIP directors and officers does not alleviate its obligations to the insured former directors and officers of the prebankrupt entity. How can a policy which excludes wrongful prebankruptcy acts help them at all? The answer is that the new deal solely benefitted National Union and Technical Equities, DIP.

An arbitrary cancellation is a breach of the covenant of good faith and fair dealing. " '[W]here a contract confers on one party a discretionary power affecting the rights of the other, a duty is imposed to exercise that discretion in good faith and in accordance with fair dealing.' " (*Spindle v. Travelers Ins. Companies, supra,* 66 Cal.App.3d at p. 958.) To exercise that power arbitrarily and to the detriment of the other party is inconsistent with that party's justified expectations.

V. Attorney Fees

The trial court awarded attorney fees to plaintiffs and cross-complainant Paul Kouns under authority of *Brandt v. Superior Court* (1985) 37 Cal.3d 813 [210 Cal.Rptr. 211, 693 P.2d 796]. Our Supreme Court in *Brandt* held that when an insurer's tortious conduct reasonably compels the insured to retain counsel to obtain benefits due under the policy, the insurer is liable in a tort action for that expense. (At p. 817.) Why? Because they are damages resulting from a tort. And, since they are recoverable as damages, determination of recoverable fees must be made by the trier of fact unless the parties stipulate otherwise. (*Id.*, at p. 819.)

Plaintiffs moved for their fees *after* judgment in the McLaughlin case wherein National Union was found to have breached the covenant of good faith and fair dealing for denying all but $10 million in coverage under the D&O policy. Kouns's award was conditioned on later determination that National Union wrongfully denied him coverage.

These awards must be reversed in light of our partial reversal. Plaintiffs and counterclaimant Paul Kouns may seek reevaluation of the propriety of such awards after the judgment in McLaughlin becomes final.

VI. Disposition

The judgment is reversed insofar as it declares that defense costs are payable under the policy in addition to the limits of liability and insofar as it declares there is $10 million in coverage for first year claims. The judgment is affirmed insofar as it declares there is $10 million in coverage for third year claims. The judgment awarding attorney fees to plaintiffs and cross-complainant is reversed, with the trial court retaining jurisdiction over the cause for possible reevaluation consistent herewith.

Perley, J., and Reardon, J., concurred.

IN THE SUPERIOR COURT OF THE
STATE OF CALIFORNIA

COUNTY OF SANTA CLARA

In Re TECHNICAL EQUITIES LITIGATION	)	COORDINATION PROCEEDING
	)	MASTER FILE
THIS DOCUMENT RELATES TO:	)	NO. 1991
HELFAND v. NATIONAL UNION, ET AL	)	Santa Clara County Superior Court
	)	No. 600306
Santa Clara County Superior Court No. 615589	)	JUDGMENT
	)	(Filed
and	)	Aug. 27, 1990)
Santa Clara County Superior Court No. 654728	)	
	)	
	)	

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I. INTRODUCTION

Defendant, National Union Fire Insurance Company of Pittsburgh, PA. ("National Union") is the liability insurer of the directors and officers of Technical Equities Corporation and its subsidiary companies ("TE"). The plaintiffs are investors in Technical Equities stock, real estate limited partnership, notes and other securities. This is an action for declaratory relief with all of the parties seeking certain declarations that focus on a policy of insurance issued to TE in 1981 and renewed in 1984. An application for insurance was executed by the then TE President, Paul Knauff, in 1981 for a three-year term. In 1984, a second policy of insurance was obtained by way of renewal application signed by Harry Stern, chairman of TE.

This Court has reviewed the evidence, considered oral arguments and read legal briefs presented by all the parties to this action. The Court has reviewed National Union's request for Statement of Decision and considered all relevant issues raised by the request. The Court, in addition, reopened the case to allow the testimony of Sal Tieri and Christopher Cavallero.

A. The Policy of Insurance.

National Union undertook to fund two separate obligations and the form of the insurance policies issued reflect that bargained for exchange. One policy insured TE's obligation to indemnify the officers and directors and the other was a policy of liability insurance for the officers and directors themselves.

The first insurance policy is denominated, "Company Reimbursement" whereby National Union promised to pay on behalf of the company any claims made against a director or officer of the company. That is, if a third party were to sue a director or officer arising out of a wrongful act in their respective capacities as directors or officers, then National Union would indemnify, and/or pay any such judgment or claim. The second contract of insurance was a directors' and officers' liability policy which extends coverage to the director and/or officer as direct insureds.

The policy has a period of August 5, 1984 to August 5, 1987. The term "policy period" which appears in paragraph seven, "loss provisions," means the three-year period from August 5, 1984 to August 5, 1987. Another term that is used in the directors' and officers' liability policy is "policy year" (see paragraph 2(b) appearing on page five) this means, simply, a one-year period commencing for example on August 5, 1984, and ending on August 5, 1985. *Exhibit* 4001.

B. Disputed Issues.

The disputed issues will be summarized here and then analyzed below.

Whether the policy is self consuming?

On a motion for summary judgment heard in February of 1988, this court ruled that because of ambiguities in the policy of insurance as well as the failure of National Union to plainly inform the directors and officers that the amount of the policy would be consumed by defense costs, that the policy was not self-consuming and that the face amount was available as indemnity in addition to the costs of defense. National Union has requested reconsideration of the prior ruling.

Whether the policy can be rescinded?

National Union maintains that the application for the original policy of insurance as well as the renewal were based on financial statements that were intentionally misleading and fraudulent. National Union seeks a declaration that the coverage is void ab initio because of the nature of these statements.

Whether the 1984 policy was canceled?

National Union attempted to cancel the policy within one month of receiving a letter from Craig Foster, Senior Vice-President of Technical Equities, advising National Union that although no lawsuits were yet filed there were a number of disgruntled investors some of whom had consulted counsel. This attempted cancellation was modified by the Bankruptcy Court, Honorable Judge Lloyd King presiding, when it approved a compromise that allowed the initial policy to be canceled provided that another policy of insurance for five million dollars be issued to cover new directors and officers for the new debtor in possession. Plaintiffs argue that the cancellation

was not effective and that they are not bound by the Bankruptcy decision. National Union claims the [B]ankruptcy decision binds, on *res judicata* principles, the plaintiffs.

Whether claims were made in the first year of the policy?

National Union asserts that the policy is divided into three separate years. Further, that all claims were made and reported in the second year. Plaintiffs assert the policy covers a continuous three year period. Furthermore, plaintiffs believe that even if the policy is divided into separate years that claims were made in the first year of the policy as well as the second and third years.

II. SELF CONSUMING

On February 10, 1988, this Court heard the motion by defendants and cross-complainants Robert Campbell, Eugene Cernan, Donald Doyle, William Gates, Weldon Gibson, Ridge Harlan, Paul Knauff, Richard Landis, Judd Leighton and William McKenna (the "Outside Directors") for summary adjudication of issues on the first cause of action set forth in their cross-complaint, and the cross-motion by defendant and cross-defendant National Union for summary judgment on plaintiffs' first amended complaint for declaratory relief and on the Outside Directors' first cause of action set forth in their cross-complaint. Written joinders in the Outside Directors' motion for summary adjudication of issues were filed by plaintiffs Helfand and defendants Joel Baylson, Ernest de la Ossa and Paul Kouns. As a result of that hearing, this Court subsequently issued a minute order granting the Outside

Directors' motion for summary adjudication and denying National Union's cross-motion for summary judgment.

The National Union 1984-1987 D&O policy is not "wasting" or "self-consuming," and National Union is obligated to pay the reasonable costs, charges and expenses of defense, including attorneys' fees of any insured under the policy, in addition to the limit of liability.

In interpreting the policy provisions, the Court was guided by the following legal principles: The law of California is clear that an insurance policy must be interpreted in a manner that gives the insured the protection he had the right to expect. *Abellon v. Hartford Ins. Co.* (1985) 167 Cal.App.3d 21, 31; *Planet Insurance Co. v. Mead Reinsurance Corp.* (9th Cir. 1986) 789 F.2d 668, 673. Insurance policies are adhesion contracts, and when drafted by the insurer, a contract's ambiguities are to be construed against it. *Id.* In interpreting the policy, the Court took into account the insured's knowledge, and exceptions to coverage must be clearly and prominently stated to be effective. *Id.* Unless a contrary intention appears, such a contract should be interpreted to embrace the costs of defense. Civil Code Section 2778(3); *Hertzka & Knowles v. Salter* (1970) 6 Cal. App.3d 325, 330 fn.4. In choosing among the reasonable meanings of an agreement or its terms, a meaning that serves the public interest is generally preferred. *Restatement 2d, Contracts* Section 207; Witkin, *1 Summary of California Law* (9th Ed. 1987) Contracts Section 683.

A "Directors and Officers Liability and Corporation Reimbursement" policy was issued to Technical Equities

Corporation on August 5, 1984 by defendant National Union. This three-year policy provides in Item 3 of the "Declarations" that the "Limit of Liability" is $10 million for each policy year.

National Union contends that the policy contains "self-consuming" provisions, *i.e.*, defense costs and other expenses payable by National Union as the insurer are deducted from the amount stated in the limit of liability, thus depleting the funds available to pay on claims for settlement or judgment.

The Outside Directors (and the parties joining in their motion for summary adjudication of issues) contend that it was not within the reasonable expectations of the insureds that the policy was "self-consuming," and that defense costs and other expenses must be borne by the insurer without depletion of the policy limits.

The National Union 1984-1987 D&O policy is ambiguous and subject to interpretation. The policy was drafted by National Union, and no evidence was introduced at the time of the summary judgment hearing to show that Technical Equities Corporation's insurance broker or any Technical Equities Corporation director had a part in the drafting of the policy.

Any "self-consuming" provisions or "self-consuming" nature of the policy are contrary to the reasonable expectations of the insureds, as a matter of law. To the extent that factual evidence regarding the insured's knowledge was presented and considered by the Court on the issue for purposes of interpretation of the policy, numerous declarations in support of the Outside Directors' motion demonstrated that the insured directors

believed and reasonably expected that they had a full $10 million per policy year as insurance coverage for claims made. National Union presented no evidence demonstrating that any particular director had read the policy or even seen the policy.

Even if a director had carefully read the policy, the policy is ambiguous, such that a normal insured would not be aware of its "self-consuming" nature. (See Ostrager & Ichel, "Should The Business Insurance Policy Be Construed Against the Insurer? Another Look At The Reasonable Expectations Doctrine." 33 Fed. Ins. Couns. Q. No. 3 (Spring, 1983), *Exhibit* 1 to the Perlis Declaration submitted by National Union.)

Although exceptions to the reasonable expectations doctrine may exist, National Union failed to show that any exceptions were applicable here.

National Union now asserts that they have new evidence that proves the TE Board knew the policy was self consuming. This evidence is in the form of several letters and memoranda that show that the insurance broker Rollins, Burdick & Hunter (RBH) informed a TE director that the policy was self consuming. The memoranda show that the policy was discussed at TE board meetings.

An example of this newly discovered evidence is *Exhibit* 4187. This exhibit is a letter that National Union believes proves that the policy was not ambiguous and shows that TE knew the policy was self consuming. This letter is from R.C. Kahn, Senior Vice President of RBH, to Herbert Bar[ov]sky, Senior Vice President/Chief Financial Officer of TE. The following paragraph is the portion of

the letter that Nation[al] Union believes provides proof of TE's knowledge that the policy was self consuming.

" 'Loss' under the policy includes damages, judgments and settlements, as well as costs, charges and expenses involved in defending claims, and . . . " *Exhibit* 4187.

This exhibit and others like it were fully considered in the prior ruling and for the reasons given in that ruling, and below, the motion to reconsider will be denied.

The ambiguity arises from several possible constructions surrounding the word "includes." When the policy holder sees that the policy "includes" the costs of defending a claim, the policy holder might reasonably conclude that the policy "includes" the costs that arise in defending against lawsuits, in addition to the liability limits of the policy. If legal expenses that arise in defending claims were to be deducted from the ten million dollar liability limit, the policy should, and could, have simply stated this fact. The expectations of the directors and officers of TE regarding costs of defense was reasonable.

Suppose R.C. Kahn had tried to explain the difference between this National Union policy and other insurance policies in his letter. He might have added this sentence: "If the company fails and misconduct of one kind or another is alleged against the officers and directors, all of the ten million dollar face amount of the policy could be used up paying attorney fees and court costs and no money will be available to pay judgments against insured officers and directors."

III. RECISSION [sic]

Whether Nation[al] Union may rescind the policy?

National Union maintains that the application for the original policy of insurance as well as the renewal were based on financial statements that were intentionally misleading and fraudulent. National Union seeks a declaration that the coverage is void *ab initio* because of the nature of these statements.

National Union issued its original policy to TE in 1981. This policy application was signed by Paul Knauff. Apparently the information for the application was provided by Herbert Barovsky with Paul Knauff signing the application as president of the company. *Exhibit* 4262. (Deposition of Paul Knauff. p. 63:9.)

The disputed insurance policy was issued in 1984, it is a renewal of the 1981 policy. The 1981 policy and the 1984 policy both contain a clause that limits the ability of the insurance company to impute the wrongful acts of one director to an innocent director. After section 4, exclusions, the policy reads:

> "NOTE: The Wrongful Act of any Director or Officer shall not be imputed to any other Director or Officer for the purpose of determining the applicability of the Exclusions enumerated in this Clause 4."

Clause 4, exclusions, contains the following paragraph:

> "The insurer shall not be liable to make any payment in connection with any claim made against the Insureds: . . . (e) brought about or contributed to by the dishonesty of the Insureds; however, notwithstanding the foregoing the

> Insureds shall be protected under the terms of this policy as to any claims upon which suit may be brought against them, by reason of any alleged dishonesty on the part of the Insureds, unless a judgment or other final adjudication thereof adverse to the Insureds shall establish that acts of active and deliberate dishonesty committed by the Insureds with actual dishonest purpose and intent were material to the cause of action so adjudicated; . . . " *Exhibit* No. 4000 and 4001. (The 1981 and 1984 Policy at page 2 of "Directors and Officer Liability" section of the policies.)

In addition to the language of the policy, communication between RBH and the insured makes it very clear that the dishonest acts of one director were not to be imputed to the other directors. In a letter from R.C. Kahn, Senior Vice President of RBH to Herbert Barovsky, Vice President of TE; Kahn explains:

> "6. There are a number of exclusions in the policy and the more important ones are: . . . (b) Coverage is excluded regarding dishonesty; however, you would have "innocent party" coverage. In other words, if one Director was unaware of dishonest acts committed by another Director, the "innocent" Director would be covered." *Exhibit* 4187. (May 14, 1984 letter, R.C. Kahn to Herbert Barovsky.)

The renewal application was a standard form that merely stated that all material in the original application would be applied towards the renewal, 1984, policy. *Exhibit* No. 4009. (Renewal application for the 1984 policy.) National Union's interpretation of its own policy, which was provided only 3 months before the renewal

policy was to take effect, should also be applied to the renewal policy.

National Union has also failed to demonstrate the importance of, and their reliance upon, the information provided in the renewal application. Peter Wilson, a senior underwriter at National Union, explained that National Union's policy was, and is, never to investigate the person signing the applications or to do any background work on an application. *Exhibit* 4249. (Deposition of Peter Wilson. p. 53:7.) Testimony of Chris Cavallero and Sal Tieri. Additionally, National Union provided no evidence that any other information was requested of TE or its officers and directors.

National Union makes no independent verification of the information set forth in the application for coverage. *Id.* at 56:2. National Union's only requirement is that the president or chairman "sign off on the application." *Id.* at 55:16. It was clearly to National Union's advantage to issue the policy and collect the premium.

It would violate princip[les] of reason and justice to allow National Union to rescind an insurance policy after having collected the premiums from that policy for the 5 years preceding any report of a wrongful act. "There is an obvious advantage to the company in obtaining payment of the premium when the application is made, and it would be unconscionable to permit the company, after using language to induce payment of the premium at that time, to escape the obligation which an ordinary applicant would reasonably believe had been undertaken by the insurer." *Ransom v. Penn Mutual Life Ins. Co.* (1954) 43 Cal. 2d 420, 425.

National Union could not have been misled by the incorrect financial statements because National Union never relied on the statements in issuing the policy. Even if National Union had relied on the financial statements the policy could not be rescinded because the terms of the policy itself and the brokers [sic] explanation clearly stated that dishonest acts of one director would not be imputed to other directors. The 1984 policy is valid as written, as issued, as paid for, it is not void *ab initio*.

IV. BANKRUPTCY AND CANCELLATION

A. Introduction

National Union received formal notice from TE that an "occurrence" had happened that might trigger claims against officers and directors of TE in a letter from TE's Craig Foster written January 30, 1986[1]. *Exhibit* 4010. TE

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[1] This is the complete text of the letter:

"Technical Equities Corporation issued a press release last week reporting that it is experiencing severe liquidity problems, expects significant operating losses due to potential revaluation of certain assets, and has appointed a new chief executive officer. In the wake of these disclosures, the company has received many phone calls from disgruntled investors. It is believed that some have consulted counsel.

We are not aware of any lawsuits that have been filed at the present time, however, we wanted to give you notice of this occurrence because it may give rise to claims being made against this company, its subsidiaries, officers and directors under the policy of directors' and officers' liability insurance issued by National Union to Technical Equities.

filed for Chapter 11 protection under the Bankruptcy Act on February 7, 1986. Within 3 months, on May 1, 1986, National Union was advising its broker to cancel the TE policy. *Exhibit* 4067. The 1984 policy, as written, would expire August 5, 1987, one year and 4 months later.

Shortly after its attempts to cancel the policy National Union sought an agreement with the new officers and directors of the TE debtor in possession. *Exhibit* 4021. In the United States Bankruptcy Court, In Re Technical Equities Corporation, Debtor, Case No. 3-86-00366LK (Chapter 11) and In Re Technical Real Estate Investments, Inc., Debtor, Case No. 3-86-00760LK (Chapter 11) National Union sought the Honorable Judge Lloyd King's approval of that agreement. *Exhibits* 4111 and 4293.

This agreement provided for the original 1984 policy to be canceled effectively on July 13, 1986 and immediately after cancellation a new policy of directors' and officers' liability insurance would be issued to the new officers and directors of the debtor in possession. This policy was to be effective from July 13, 1986 to July 13, 1987. This agreement was approved after a hearing on July 28, 1986. The order was signed and entered on the Bankruptcy Docket on August 5, 1986. *Exhibit* 4293. This

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If any complaints are served upon the company, we will notify you immediately and tender the defense to you.

Yours truly,

Craig A. Foster
Senior Vice-President"

Exhibit 4010.

policy was to cover directors' and officers' liability and corporation reimbursement of the debtor in possession for acts occurring after the bankruptcy, although the binder, on its face, insures Technical Equities Corporation. *Exhibit* 4002.

National Union has asked this Court to declare that certain outside directors, who were neither members of the Board of Directors of the debtor in possession, nor parties to the proceeding are bound, on *res judicata* principles, by Judge King's ruling approving the above-mentioned agreement.

National Union also attempted to interplead the proceeds of the second year policy amount, ten million dollars, and has sought discharge in the Bankruptcy Court. Judge King, however, denied the request for discharge on the ground that the State Court had not yet determined the appropriate amount of the stake in the interpleader action. U.S. Bankruptcy Court, Case No. 3-86-00366LK, Chapter 11, Adversary Proceeding No. 3-86-0449LK, Friday, July 29, 1988, Motion to Confirm Rule 22 Interpleader. At this bankruptcy hearing, Michael Perlis, appearing on behalf of National Union, stated: "We are not trying to resolve any alleged bad faith claims; or seeking at this point to determine the policy limit of the National Union D & O policy; . . . " Transcript of Bankruptcy Hearing, July 29, 1988, p. 6:17-19. Later, Mr. Perlis said that he did not believe that the number of policy years needed to be resolved at that hearing. *Id.* at 12:12-17. The bankruptcy judge stated that he believed Mr. Perlis was not seeking a determination of the policy limits at the hearing. *Id.* at 20:9-15. In making his final ruling, Judge King said that he was "influenced by the

statements of counsel for National Union that it was not at this time requesting a determination of bad faith issues, policy limits, or discharge." *Id.* at 35:1-4.

Plaintiffs claim that the policy could not be canceled, that directors and officers were not bound, that proceeds from the third year are available under the policy in the amount of ten million and that the Debtor-In-Possession policy provides for an additional five million in coverage.

Finally, in addition to the above policies, TE activated a so called "discovery tail." This discovery tail allows an extended period of time in which to discover claims which may have been made under a pre-existing policy. This extended period of discovery was purchased for an additional premium of 15% of the original 3 year premium. *Exhibits* 4024 and 4025.

The "discovery tail" is made available in paragraph 8(a) of the 1984 policy and modified by endorsement number ten of the policy. Endorsement ten provides that after cancellation or refusal to renew, the insureds would have the right "upon payment of an additional premium of 15% of the three-year premium hereunder to an extension of the cover granted by this policy . . . of 180 days . . . . " Paragraph 8(b) of the Directors' and Officers' policy gives National Union the right to cancel upon notice with "payment or tender of any unearned premium by the insurer . . . . " Payment of the unearned premium is not a condition precedent to the effectiveness of cancellation "but such payment shall be made as soon as practical." Whether the unearned premium was returned is disputed. Chris Cavallero testified that no

investigation of TE occurred prior to the decision to cancel.

B. Bankruptcy Analysis

National Union contends that, as a matter of law, coverage under the third policy year, of the 1984 policy, does not exist because any coverage for that year was canceled before the policy year even began, in a compromise approved before the Bankruptcy Court. National Union believes the cancellation is effective and that any attempt by plaintiffs' [sic] to establish coverage for the third policy year would be an impermissible collateral attack on a prior order of the Bankruptcy Court that is barred by the doctrine of *res judicata*.

National Union contends the doctrine of *res judicata* binds plaintiffs because plaintiffs were either a party to the bankruptcy proceedings, having received notice of those proceedings, or plaintiffs were in privity with those who were parties to those proceedings. National Union believes privity exists among the plaintiffs because: (1) the non-party plaintiffs had an identity of interest with, and adequate representation by the losing party in the first action; and (2) the non-party plaintiffs should reasonably have expected to be bound by the prior adjudication. National Union also contends the community of interest is so strong between plaintiffs and the participants in the Bankruptcy hearing that such participants can fairly be considered to have acted in a representative capacity.

When the Bankruptcy Court has jurisdiction over the parties, when the plaintiff creditor has notice of the

compromise proceeding, and there is no allegation of fraud, there can be no collateral attack on a Bankruptcy Court order approving a compromise. *Mueller v. Elba Oil Co.* (1942) 21 Cal. 2d 188, 206.

Plaintiffs contend they are not bound by the Bankruptcy Court order because they were not given proper notice of the hearing, they were not represented at the hearing and there was no true adjudication of the issues at the Bankruptcy proceedings. Plaintiffs concede that had they been represented at the Bankruptcy proceedings and participated in the compromise, they would be bound by its orders. Plaintiffs' [sic] argue that they cannot be bound by a compromise between National Union and the TE companies.

National Union argues that the Helfand's, as third-party claimants, have no independent rights to assert with respect to the agreed upon cancellation of the Policy. National Union also contends plaintiffs had no contractual rights and they were not third-party beneficiaries of the Policy. National Union cites, *Spearman v. State Farm Fire & Casualty Co.* (1986) 185 Cal.App.3d 1105, for the rule that "[a] third party should not be permitted to enforce covenants made not for his benefit, but rather for others. He is not a contracting party; his right to performance is predicated on the contracting parties' intent to benefit him." *Id.* at 1110. The insurance policy is a personal contract between the insured and the insurance company where the insurance company agrees to indemnify the insured against liability for loss; it is not a contract of liability to third parties. *Van DerHoof v. Chambon* (1932) 121 Cal.App. 118, 131.

In *Spearman* the plaintiff sued the insurance company in tort for failure to conduct an investigation to discover plaintiff's share of damages paid by defendant insurance company to plaintiff's wife, from whom he was separated. In *Van DerHoof* the plaintiff attempted to join the insurance company with the negligent defendant driver to recover damages for personal injuries sustained by plaintiff in an automobile collision with defendant driver. The third parties were not allowed to bring their causes of action in those situations because "[a]s a general rule the only party entitled to sue on such a contact [sic] is the indemnitee or someone in his right, such as his assignee. A third person, although he may have an interest in the subject matter of the indemnity, and a right of action against the indemnitee, not being a party to the indemnity contract, is not entitled to sue thereon in his own name . . . " *Van DerHoof v. Chambon,* 121 Cal.App. at 130.

The issue here however is not whether plaintiffs had a right to sue National Union either in Bankruptcy Court or in this Court. The issue is whether the plaintiffs had an interest in the Bankruptcy Proceedings and whether the Bankruptcy compromise deprived plaintiffs of that interest.

"[H]e [the injured party] has a cause of action against the insurer at the time he is injured that ripens into a right of action when he recovers a judgment against the insured." *Shapiro v. Republic Indem Co. of America* (1959) 52 Cal.2d 437, 439. *Shapiro* concerned a declaratory relief action to reform an insurance policy. The reformation would have denied relief to the plaintiffs. The plaintiffs were not a party to the declaratory relief action that

reformed the policy. The Supreme Court refused to allow the reformation to affect the rights of the plaintiffs.

> "As third-party beneficiaries of the policy, plaintiff then had an interest that could not be altered or conditioned by independent action of the insurer and insured. (citation) Nor can their rights be conclusively determined against the injured persons in an action to which they were not made parties." *Id.* at 440. See also, *New Amsterdam Casualty v. Murry* (6th Cir. 1957) 242 F.2d 549. (An injured persons rights arise upon the happening of an accident, and can not thereafter be abridged by a judgment to which she is not a party.)

The plaintiffs in this *Helfand* case had an interest in the Bankruptcy compromise because the injury to plaintiffs occurred before the Bankruptcy hearing.

The general or *in rem* aspects; e.g., approving sales and leases of property, proposing a plain, [*sic*] approving attorney and trustee fees and confirming a plain [*sic*] of reorganization: Lists of many of these items are set forth in Bankruptcy Rule 2002, subdivisions (a), (b), and (f). This Rule concerns notice given to all creditors (or to a creditor's committee and those who have requested special notice under Rule 2002(i)) because the matters bear on the interests of creditors generally. A "compromise of controversy" is included within this list.

Individual disputes or *in personam* aspects of the case: *Commercial Western Finance* (9th Cir. 1985) 761 F.2d 1329 is an example of an *in personam* proceeding. There, the trustee was setting aside or avoiding security interests.

The Ninth Circuit held that this could only be done by an adversary proceeding (i.e., suing the security holders) and not by the *in rem* plan confirmation process. *Commercial Western Finance* was followed by *In re Golden Plan of California, Inc.* (9th Cir. 1986) 829 F.2d 705, where the court of appeals ruled that actions of both the bankruptcy court and the district court had improperly affected rights without an adversary proceeding. It should be noted that the district court action was not an appeal from the bankruptcy court. The investors filed a complaint in the district court to challenge the earlier decision – obviously a collateral attack – but this aspect of the case was mentioned only in passing. *Id.* at 708.

The distinction between *in rem* and *in personam* proceedings within a bankruptcy case is obvious in one extremely common situation where both the *in rem* aspects and the individual rights of third parties are often involved – sales of bankruptcy estate assets. In "Practice Pointers" distributed by the San Jose bankruptcy judges, it is pointed out that when the proceeds of a sale will not be sufficient to allow a full payoff of all secured creditors who hold interests in the property, the sale procedure requires two motions in order to sell the property free and clear of the liens: (i) the *in rem* procedure to obtain approval of the sale, where the issue will be whether the sale is in the best interest of creditors and the estate, and (ii) the *in personam* aspect where the question will be whether the secured creditor's rights will be protected. Under Rule 6004(c), this *in personam* aspect requires a contested matter type of procedure so that the secured creditor's substantial property rights can be protected.

The July 28, 1986 compromise of controversy motion in this case was not the usual compromise between consenting parties but involved two separate aspects: (i) approval of the compromise, i.e., was the compromise in the best interest of creditors, the *in rem* aspect, and (ii) approval of taking away the insurance from the officers and directors, i.e., were the rights of the insured directors and officers being protected or were they to be improperly sacrificed for the benefit of the debtor and the creditors generally, the *in personam* aspect. The directors and officers do not address their arguments to the *in rem* aspect of the "compromise" motion and whether the notice was adequate for those purposes or whether the creditors committee could represent them insofar as they were only general unsecured creditors. The directors and officers are concerned instead with the *in personam* part of the motion, where the debtor and its insurance company agreed that the officers and directors would give up ten million dollars of third year insurance coverage. This aspect of the motion was obviously *in personam*. The notice was clearly inadequate for this purpose; e.g., it was labeled as a compromise between Technical Equities and National Union, it talked as if there was only one ten million dollar policy amount. The notice did not suggest that ten million dollars of insurance coverage would be lost for claims made during the third year, it did not advise the directors and officers that they would lose substantial rights, it gave the directors and officers only a few days to respond although there was no emergency, and the notice was addressed "To All Interested Parties:" although there was certainly no difficulty in including the names of all of the officers and directors in the salutation.

In addition, as to this *in personam* aspect of the "compromise," the creditors committee could not represent those who stood to lose their insurance protection. The creditors committee obviously favored this compromise that benefited the debtor's continued existence.

Thus, there is no *res judicata* in this matter where the directors and officers were not properly given notice and an opportunity to [be] heard. The leading case in this regard is *Mullane v. Central Hanover Bank & Trust Co.* (1950) 339 U.S. 306. *Mullane* concerned the constitutional sufficiency of notice by publication to beneficiaries of common trusts for hearings on the settlement of trust accounts. The Supreme Court held the published notice was insufficient. It pointed out that:

> "An elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections. (Citations.) The notice must be of such nature as reasonably to convey the required information, (citation), and it must afford a reasonable time for those interested to make their appearance. (Citations.)" 339 U.S. at 314.

The court added that:

> "But when notice is a person's due, process which is a mere gesture is not due process. The means employed must be such as one desirous of actually informing the absentee might reasonably adopt to accomplish it." *Id.* at 315.

The cases National Union cites for *res judicata* are readily distinguishable. Most of the cited cases rely on *Chicot County Drainage District v. Baster State Bank* (1940) 308 U.S. 371. That case concerned the *in rem* aspects of the bankruptcy, the confirmation of a plan of arrangement that altered the creditors' claims of the respondent. There was no suggestion of a failure to give adequate notice and an opportunity to litigate. National Union also cites *Levy v. Cohen* (1977) 19 Cal.3d 165 a case involving the *in rem* aspects of the bankruptcy and plan confirmation. There, the California Supreme Court relied on *Chicot County* and noted that there was no suggestion of lack of notice and opportunity to be heard. The Court stated that the plaintiff: "does not suggest that he was denied an opportunity . . . to raise his objection that the bankruptcy court lacked jurisdiction to discharge defendants from liability for the obligations of the limited partnership." *Id.* at 174.

In *Heffron v. Rosenberg* (1942) 51 Cal.App.2d 156, where the bankruptcy trustee had settled a claim with a third party, the bankrupt sued on the same claims, the court reasoned that all of the bankrupt's rights had passed to her trustee, and he was entitled to enter into the settlement. Applied to the facts of our case, *Heffron* would mean only that Technical Equities was bound by the settlement. There is no discussion in the case as to whether or not the bankrupt received notice of the bankruptcy court hearing on the settlement.

In *Martin v. Martin* (1970) 2 Cal.3d 752, the subject was the bankruptcy court's actions concerning a portion of an interlocutory judgment of divorce. Both parties to the state court case had appeared and litigated in the

bankruptcy court and there was no question of bankruptcy court jurisdiction over them. In *Miller v. R.K.A. Management Corp.* (1979) 99 Cal.App.3d 460, a case concerning a suit by officers and directors of a bankrupt corporation to set aside a bankruptcy court sale of the corporation's real property, the only issue was an *in rem* action of the bankruptcy court. Although the sale was "free and clear of all liens," there is no discussion of the effect of the sale on any lien claimant's rights.

In *Muller v. Elba Oil Co.* (1942) 21 Cal.2d 188, the order in issue was the approval of a compromise by the bankruptcy referee that discharged the individual partners of the bankrupt partnership in exchange for payment of $7,500 to the trustee. At the time, there was a substantial question as to whether the discharge of a bankrupt partnership would also discharge the partners. No issue was raised as to notice to the plaintiff. The plaintiff was a creditor, and the order of the bankruptcy referee approved a compromise by the estate. Plaintiff's only interest was as a creditor. In other words, plaintiff was questioning an *in rem* proceeding in the bankruptcy, and plaintiff did not raise any issue as to notice or opportunity to be heard at the hearing on the settlement.

In the present case, the individual rights of the directors and officers were in issue and the notice surely would not bring home to them that the debtor and National Union proposed that these valuable rights were to be donated to the common good.

In addition to the lack of clarity, as shown above, the notice did not give the directors and officers sufficient time to prepare and present a defense. Also, the notice

failed to comply with the bankruptcy rules regarding either advisory proceedings or contested matters. Further, the notice failed to comply with the bankruptcy judge's order establishing a notice procedure because (a) it required the filing of evidence with any objection, and (b) it did not concern the *in rem* types of matters that were to be the subject of the type of notice described in the order. As pointed out in the Restatement of Judgments, Second, at section 2(1)(c) notice is only adequate if the form of notice and the method employed for transmitting it sufficiently comply with the prescribed procedure for giving notice. A summons and complaint, beginning an adversary proceeding, or a motion, commencing a contested matter, would have been necessary here. See Bankruptcy Rule 7004.

National Union cites *Matter of Gregory* (9th Cir. 1983) 705 F.2d 1118 as indicating that there may be "constructive" or "inquiry" notice from documents served in a bankruptcy case. Although the *Gregory* case had broad language in this regard, the facts show an unsecured creditor claiming he did not realize he would be paid nothing under the debtor's Chapter 13 plan when the notice he received said: "The debtors: plan does not propose payment of unsecured creditors." The court was surely reasoning that the creditor should not have withheld action in the belief that this plain and clear statement was ambiguous; i.e., he should have checked the court file instead of thinking this statement held out the hope that he would be paid. In short, there was clear actual notice in *Gregory*. Also, it should be noted that the case dealt with plan confirmation, an *in rem* part of bankruptcy cases, and that the form and manner of notice was

sufficient under the Bankruptcy Code and Rules. In the instant case, the notice did not satisfy the requirements of Rules 7001 and 9014.

The controlling case on inquiry notice in bankruptcy is *City of New York v. New York, N.H. & H.R. Co.* (1953) 344 U.S. 293. There, although the city knew of the pending railroad reorganization case, it had no duty to inquire concerning the case, and it was entitled to mailed notice of the deadline or bar date for filing claims. Justice Black stated: "Nor can the car order against New York be sustained because of the city's knowledge that reorganization of the railroad was taking place in the court. The argument is that such knowledge puts a duty on creditors to inquire from themselves about possible court orders limiting the time for filing claims. But even creditors who have knowledge of a reorganization have a right to assume that the statutory 'reasonable notice' will be given them before their claims are forever barred. When the judge ordered notice by mail to be given the appearing creditors, New York City acted reasonably in waiting to receive the same treatment. "The statutory command for notice embodies a basic princip[le] of justice – that a reasonable opportunity to be heard must precede judicial denial of a party's claimed rights. New York City has not been accorded that kind of notice." 344 U.S. at 297.

National Union claims that the Notice of Hearing "clearly spelled out the compromise" and the directors and officers "were given a full opportunity to file objections and appear at the [July 28, 1986 hearing.]" This is not so. Even today the notice is not clear although we now know what National Union sought to do. How could directors and officers be expected to understand in July

1986 that this notice meant that a third ten million dollar year of insurance might be lost? Indeed, the notice (p. 1, line 22) says that there is "a *$10,000,000* policy limit," not the three ten million dollar limits that the policy actually provided. (Emphasis added [by trial court].)

As to a full opportunity to file objections and be heard, the notice said that to object one must file and serve on counsel "written notice of any objections and copies of all evidence in support thereof within ten (10) days after service of this notice." Notice of Hearing, p. 2 lines 22-23. In other words, officers and directors had 10 days, less the mailing time, to gather evidence, draft objections and file and serve their objections.

Bankruptcy Rule 7012(a) allows 30 days for filing an answer to an adversary proceeding. Northern District Local Rule 9 (now Rule 740-7) required service of the moving papers for a contested matter at least 30 days before the hearing date and gave 14 days to respond. Although the Bankruptcy Rules authorize shortening of time, there was no such order here – only an order establishing notice procedure, which related only to *in rem* matters under Bankruptcy Rule 2002(a).

National Union urges that the bankruptcy judge has exclusive jurisdiction over the question of policy limits. This argument ignores the fact that there were two policies of insurance within the single document: one regarding Technical Equities' obligation to indemnify the directors and the other a policy of liability insurance for the officers and directors themselves. See, *In re Louisiana World Exposition, Inc.* (5th Cir. 1987) 832 F.2d 1391 where the court held that, although the debtor, the employing

corporation, might own the insurance policy, the policy proceeds were not part of the bankruptcy estate and the officers and directors were entitled to them.

Of even greater importance is the fact that the bankruptcy court has authorized this action to determine insurance coverage to proceed. Paragraph 4 of the October 5, 1987 stay relief order.

Additionally, District Judge Spencer Williams has ruled that the interpretation of this particular insurance policy is not a subject of bankruptcy jurisdiction because it does not address the question of whether the policy proceeds are or are not assets of the bankruptcy estate.

MacArthur Co. v. Johns-Manville Corp. (2d Cir. 1988) 837 F.2d 89 does not bear upon the facts here. In that case the court stated that the vendor's rights "are completely derivative of Manville's rights as primary insured." *Id.* at 92. Here, the directors and officers are primary insureds who have their own policy. In *MacArthur* the bankruptcy court had found, as a fact, that permitting actions against the insurers would interfere with the reorganization. *Id.* at 93-94. Here there is no such finding, and payment by the insurer would not interfere with reorganization. National Union could not cancel the third year of insurance. This Court is not bound by the Bankruptcy Court's July 28, 1986 order, even if it purports to authorize the cancellation. The directors and officers were not properly served and made a party to the hearing, insofar as it attempted to deprive them of their individual property rights.

The following counsel were present at the Bankruptcy proceedings that approved the compromise on

Monday July 28, 1986. For the Debtors: Lawrence Peitzman, Esq. of Gendel, Raskoff, etc. and George Yuhas, Esq. of Orrick, Herrington, etc. For the Unsecured Creditors' Committee: James Lopes, Esq. and Michael Eagan, Esq. of Howard, Rice, etc. For General Electric Credit Corp.: Margaret Sheneman, Esq. and Jane Springwater, Esq. of Murphy, Weir, etc. On Behalf of Certain Class Action Plaintiffs: George Donaldson, Esq. For Security Pacific Bank: Karen Heilman, Esq. of Lillick, McHose, etc. For Bank of the West: Gary Nemer, Esq. of Buchalter, Nemer, etc. *Exhibits* 4111 and 4293.

General Electric Credit Corporation appeared at the Bankruptcy hearing to request the approval of the sale of the assets of Coast Fabrication and was not involved in the compromise. The Class-Action Plaintiffs appeared at the hearing to discuss a motion by the debtor to borrow money to conduct an investigation. Security Pacific Bank and Bank of the West were present at the hearing to discuss Chapter 11 financing agreements and to argue a motion by the debtor to borrow $350,000 from Security Pacific National Bank, Pacific Valley Bank and Bank of the West to help fund certain causes of action being pursued by the creditor's committee.

The compromise was offered to the Bankruptcy Court by Mr. Peitzman and Mr. Yuhas for the Debtor. The compromise was formulated between Mr. Yuhas and National Union. The Unsecured Creditors' Committee was not involved in the compromise and its attorneys did not speak at the hearing. The plaintiffs, therefore, were not represented at the hearing. *Exhibits* 4111 and 4293.

As explained above, the compromise was only binding between the TE Debtor in Possession and National Union. The plaintiffs are not bound by the order of the Bankruptcy Court.

C. Cancellation of the Policy

Preliminarily the Court notes that in California even a valid cancellation of a policy of insurance "does not have the effect of releasing the insurer from liability which accrued prior thereto by reason of the happening of the contingency insured against." *Fields v. Blue Shield of California* (1985) 163 Cal.App.3rd [sic] 570, 585.

The attorneys for director and officer Paul Kouns argue on technical grounds that National Union had no right under California law to cancel the policy. The argument is that under Insurance Code Section 661 notice of cancellation was improper as not coming within any of the specified grounds for cancellation found therein. National Union argues that Section 661 does not apply because Insurance Code Section 675.5 excludes commercial lines. Kouns, however argues that Insurance Code Section 675.5 was not effective until January 1, 1987 and did not apply to any policy prior to that date. Thus, the section that governs commercial lines at the time that this policy was issued, August 5, 1984, was Insurance Code Section 675 which, when read specifically, does not include risks arising from a commercial enterprise. The code section that actually governed was Insurance Code Section 660 et seq. National Union argues that Insurance Code Section 661 only applies to automobile insurance because of its reference to driver's licenses.

California Insurance Code Section 661 is in GENERAL PROVISIONS, DIVISION 1, PART 1, Chapter 10 of the Insurance Code, CHAPTER 10. CANCELLATION OR FAILURE TO RENEW. The first section in Chapter 10, section 660, provides definitions for the Chapter. Section 660 defines "Policy." "As used in this chapter: (a) 'Policy' means an automobile liability, automobile physical damage, or automobile collision policy, . . . and under which the insured vehicles therein designated are of the following types only . . . " California Insurance Code Section 660.

Section 661 then describes several types of vehicles. The language, terms and description are clear and unambiguous. Chapter 10 applies only to automobile policies. Section 661 is in Chapter 10. Insurance Code Section 675.5 is in DIVISION 1, PART 1, Chapter 11. CHAPTER 11. CANCELLATION AND FAILURE TO RENEW CERTAIN PROPERTY INSURANCE. The first section in Chapter 11 is Section 675. Section 675 explains that Chap[t]er 11 shall apply only to policies of insurance that insure real or personal property. This section is modified by Section 675.5 which explains that as of 1987 the chapter shall apply to policies of commercial insurance. "Section 675.5 Application of chapter to certain policies of commercial insurance. (a) In addition to any policy of insurance specified in Section 675, this chapter shall apply to policies of commercial insurance issued . . . and take effect or are renewed on or after January 1, 1987." The Historical Note in West Annotated Code explains that this was 1986 Legislation and that, "This act shall be known as the Robbins-Brown Insurance Consumer Reform Act of 1986." Finally there is Section 676.2 entitled, "Policies of

commercial insurance; grounds for valid notice of cancellation," that governs cancellation of commercial insurance issued after Jan. 1, 1987.

The Court has not been advised of any authority, nor has it found any authority, to suggest that Section 660 should apply to this disputed 1984 policy. Section 675.5 and section 675 by their clear and unambiguous language only applied to property insurance before 1987. Only after 1987 do they apply to all commercial insurance as required under the Robbins-Brown Insurance Consumer Reform Act of 1986.

The first notice National Union had of any claim against TE was from Craig Foster's January 30, 1986 letter. Technical Equities filed for Chapter 11 protection under the Bankruptcy Act on February 7, 1986. National Union's Senior Vice-President Chris Cavallero decided to cancel the policy in March of 1986. Mr. Cavallero was promoted to senior vice president of Directors and Officers underwriting division at National Union in 1980 and he held that post until he left National Union on April 27, 1986. Thus, within one month of the Craig Foster letter, National Union decided to cancel TE's 1984 policy. The policy was due to expire August 5, 1987, a year and five months after National Union's attempted cancellation. A fair reading of Cavallero's deposition shows that National Union did not do any investigation, that there was no evidence that any outside director had committed fraud and that it was only his lawyer that gave him a "gut feeling" that some individuals at Technical Equities were guilty of gross fraud. *Exhibit* 4245 p. 86 lines 2-6. Mr. Cavallero also knew of no other situations where National Union had cancelled where the premium had

been prepaid and the company had filed for bankruptcy and that this is the only case where the company cancelled a policy because of gross fraud. "Quite frankly, Technical Equities is the only case I can rightfully remember where I actually canceled the policy. Where I was aware of the egregious type of fraud . . . " *Exhibit* 4254 p. 111 lines 12-20.

At National Union's insistence this case was reopened to allow the live testimony of Chris Cavallero. On the witness stand Cavallero testified that he had no personal knowledge of fraud at TE until 1989 when he saw the judgments from this coordinated action. Under either version of Cavallero's testimony the attempted cancellation was arbitrary and without legal justification. The cancellation was also improper under the terms of the policy because the payment of the unearned premium was not returned. The insurance purchased by this company was for the benefit of its investors, many of whom were aged persons who had invested their life savings with Technical Equities. At the time of the cancellation National Union knew, or had reason to know, that the cancellation would have the effect of cutting off the rights of those investors.

When National Union purported to cancel the policy it never returned the unused portion of the prepaid premium to TE. National Union assumed it was entitled to keep the premium. National Union used the following reasoning: The prepaid premium cost $30,290. *Exhibit* 4018. After cancellation National Union owed TE the unused pro rata share of the prepaid policy. But when the policy was cancelled TE wanted to exercise the "discovery tail." This "tail" attached to the cancelled end of the

policy and extended discovery of possible claims for 6 months after cancellation. The cost of this "discovery tail" was 15% of the premium or $4,544. *Exhibit* 4018. TE now presumably owed this amount to National Union. TE also owed National Union for the premium for a Debtor in Possession policy that National Union would issue as part of the compromise package, the five million dollar policy that lasted one year and covered the Officer and Directors for actions that took place after the Bankruptcy. The amount of this premium would equal whatever amount National Union owed TE from the unreturned portion of the cancelled premium that was not consumed by the $4,544 owed National Union for the "discovery tail." This amount was $6,178. *Exhibit* 4022. (Internal Memo to Janet Makowsky of Rollins, Burdick and Hunter.)

By this calculation everything was a wash, nothing was owed anyone. The $10,722 that National Union owed TE from the cancellation is balanced by the "discovery tail" fee of $4,544 and the fee of $6,178 for the Debtor in Possession policy. *Exhibit* 4066. (Internal AIG memo from Stella Cannestra to Lene Tvedten, "no one owes anyone anything." dated 7/30/86.)

Unfortunately things didn't end up washing very cleanly, because TE's counsel, George Yuhas, mailed National Union a check for the "discovery tail" fee of $4,544 on August 8, 1986. This $4,544 was never returned to TE. *Exhibits* 4024 and 4025. (Exhibits show Yuhas sending the check, not the fact that amount was never returned.) For the purposes of this decl[ar]atory action this Court will not draw any conclusions concerning Nation Union's purpose in keeping this check. Nor does

this Court conclude that the check was accidentially [*sic*] or intentionally retained by National Union.

V. VALUE OF THE POLICY

Because the cancellation was improper, the third year of the premium covered the same period as the "discovery tail." The discovery tail therefore was meaningless. The third year of the premium applies to TE officers and directors concerning activities that occurred before the Bankruptcy filing on Feb. 7, 1986.

The Debtor in Possession policy of five million dollars is valid because the Debtor paid valuable consideration for the policy. This policy covers TE the debtor in possession, and its officers and directors (a different set) for any covered acts that occurred after the Board was under the supervision of the Bankruptcy Court. This Court is not aware of any reported claims that would be covered by this Debtor in Possession policy.

The [P]remiums. National Union does not have to return the cancelled premium amount of $10,722 to TE. TE does not owe National Union the 15% premium for the discovery tail premium that it paid National Union. National Union owes TE the 15% discovery tail premium that it collected from TE the debtor. Finally, TE the debtor owes National Union the premium for the Debtor in Possession for the one year five million dollar policy, this amounted to $6,178. So National Union must return the $4,544 it collected from TE for the discovery tail but TE owes National Union $6,178 for the Debtor In Possession policy. This means that TE the debtor currently owes National Union $1,634 in premiums.

Claims may be made for the third year under the 1984 policy, for any losses caused by the pre-Bankruptcy Officers and Directors of TE from August 5, 1986 to August 5, 1987. The Debtor in Possession policy covers the post-Bankruptcy board of directors for any events caused by the post-Bankruptcy Officers and Directors of TE for events occurring from July 13, 1986 to July 13, 1987. The value of the 1984 policy then is ten million dollars per policy year for the three policy years of the premium. Whether or not ten million dollars can be claimed for each year depends upon the claims made under the policy.

VI. CLAIMS MADE UNDER THE POLICY

A "claim" is "made" against the insured company, meaning Technical Equities. The "report" of the claim is then made to the insurance company, National Union. (See paragraph 7(a) of the policy, *Exhibit* 4001). A "report" which may be "written or oral notice" includes an " . . . intention to hold the insureds responsible . . . " paragraph 7(c)(i). *Exhibit* 4001.

A. What is a Claim?

The policy is ambiguous in that a "claim" is not defined under the terms of the policy; except that it is at least, " . . . written or oral notice from any third party that it is the intention of such third party to hold the insureds responsible for the results of any specified wrongful act . . . " Therefore, all ambiguities as to its meaning must be construed in favor of the insured. The definitional task of defining a "claim" has two boundaries. Clearly, the filing of a lawsuit is a claim. The lower boundary of a

claim however is not clear. It involves an intention to hold someone responsible. The parties have the same difficulty in asserting the nature of a "claim" as does the policy.

Perhaps it is inherent in the language that very general terms will invariably become indefinite at the edge. One characteristic of this indefiniteness is the assertion by National Union that the letter of Craig Foster of January 30, 1986, asserts a "claim."

On January 30, 1986, an officer of Technical Equities, Craig A. Foster, Senior Vice-President, wrote National Union to inform National Union of various events, such as liquidity problems and phone calls from disgruntled investors, that, "may give rise to claims being made against the company. (i.e. TE)." See, *footnote*1.

The text of the letter, set out in full in *footnote*1, is some evidence of someone's intent to hold the insureds responsible. It is, however, no evidence whatever of who those third persons are, or what any wrongful act is, or when it occurred. It does say that the chief executive has resigned, the company may go into bankruptcy and the accounting statements may be changed. A lawyer or an experienced claims adjuster would see this as trouble ahead, but it does not appear to satisfy the minimal conditions of paragraph 7(c)(i) " . . . written or oral notice from any third party that it is the intention of such third party to hold the insureds responsible for the results of any specified wrongful act by the insureds. . . . " This is probably not an issue in this case because of National Union's agreement that the letter does constitute a report of a claim.

The use to which National Union, however, puts this proposition shows the subtlety and cleverness of their argument. National Union has treated the Craig Foster letter as a report of the claims of all of the persons who have filed suit in these coordinated proceedings and taken the position that because the report of a claim occurred in the second policy year of the three-year policy period only the sum of ten million dollars is available to pay these claims.

A "claim" can be as minimal as complaining about a condition. *J.G. Link and Company v. Continental Casualty Company* (9th Cir. 1972) 470 F.2d 1133 (complaint of squeaky floors).

The plaintiffs maintain that the January 30, 1986, letter is merely the "report," to National Union of "claims" previously made to the insured, TE, in the first policy year. As an offer of proof, plaintiffs offer numerous examples of these so called "claims."

National Union argues that not only is the letter a report of a claim, it is a report of all claims that occurred up to January 30th and all claims occurring at any time thereafter. Thus the letter becomes not only a report of existing claims but a report of all possible claims. Why would the company treat this letter so generously? The answer lies in the nature of a "claims-made" policy.

With a "claims-made" policy the insurance company indemnifies the insured for all claims-made [sic] against the insured during a specified period. If the claims are made during only one policy year, instead of three, National Union's exposure under the policy drops from thirty million to ten million dollars.

National Union argues that even though the policy doesn't say it, the policy is, in fact, divided into three parts and that each part has an indemnity value of ten million dollars so that only the claims made within a "policy year" are payable from the ten million dollars allocated thereto. This view is not supported by the language of the policy. Paragraph 7(c)(2) says, "that if the company (T.E.) receives a claim within the "policy period" and it is reported to National Union, the insurer thereafter, then it is treated (if arising out of a wrongful act) " . . . as a claim made during the currency hereof." "Hereof" refers back to "policy period," so for clarity instead of using "hereof," the policy could have said, "claim made during the currency of the policy period."

In National Union's request for statement of decision it requests this Court to determine whether a delay in reporting claims caused National Union to suffer any prejudice. Yet, in National Union's trial brief at p. 5, footnote 5 it states: "This rule, known as the 'notice-prejudice' rule, is not an issue in this case." Nevertheless, National Union presented no evidence of prejudice for any alleged delay in notifying National Union of claims, and indeed seem to concede in its trial brief that no prejudice exists.

Though this is not an "occurrence" policy, the events (wrongful acts) that occurred during this three-year policy period were distributed throughout the period. For example, most of the real estate losses occurred in year one, virtually all of the stock losses in year two, and some further real estate losses, subsidiary company failures, etc. occurred in year three. Under the law a claim is "made" when it is made to the insured, TE, not when

notice is given to the insurance company. *Phoenix Insurance Company v. Sukut Construction Company* (1982) 136 Cal.App.3d 673.

Offers of Proof

If plaintiff[s'] offer of proof is true concerning when the Helfands' and others made claims to Technical Equities then there were at least 20 to 30 claims made during the first policy year and a very large number, all by way of lawsuits filed, in the second year and an additionally large number in the third year.

Paragraph 7, "loss provision," of the Policy, means that a claim made during a policy period picks up the indemnity amount available in the policy year in which it was made. Thus, the claims were made in this case throughout the three-year "policy period."

One example is that of Robert and Martha Gaspitch, investors in a T.E. Real Estate Limited Partnership known as KS Associates. They demanded the return of their money from an officer of Technical Equities, Ray Wahba, in the spring of 1985, claiming that Technical Equities sold the underlying property in KS Associates in May of 1985 thereby entitling Dr. and Mrs. Gaspitch to $73,000 of the proceeds thereof. Their claim is that Technical Equities wrongfully refused to return their money. If their claim was to Wahba in the first policy year, the first year's 10 million dollars would be available notwithstanding the fact that the "report" of claim to National Union did not occur until the second year.

B. When is a Claim Made?

The question of exactly when the various claims were "made" has been the subject of further hearings held before Special Master James McManis who took evidence concerning those claims and submitted his report to the Court. Following submission of the report, the parties stipulated to a general reference of the issue of first year claims to the Special Master, who conducted further hearings and filed a tentative decision on the issue. The tentative decision on first year claims is now incorporated into this Final Judgment in the section below.

First Year Claims

The issue tried by the special master is the defendant's liability for claims made during the first policy year of the 1984-1987 policy. The court announces its decision on this issue. Defendant's liability for such claims is $10 million.

PRELIMINARY STATEMENT

On January 16, 1990, the Special Master filed his report on the dates of claims made during the first policy year. On the same day, the parties agreed in open court on the record to refer the issue of first year claims to the Special Master for decision. The court made the reference. The special master conducted further proceedings. On February 2, 1990, the parties submitted the case. Pursuant to Rule 232.5 of the Rule[s] of Court, the Special Master's findings are incorporated into this final judgment.

THE INSURING AGREEMENT

The insuring agreement (Para. 1, Insuring Clause) of the directors and officers liability part of the policy provides in part:

> "This policy shall, subject to its terms, conditions and limitations as hereinafter provided, pay on behalf of each and every person who was or now is or may hereafter be a Director or Officer of the Company named in Item 1 of the Declarations (who are hereinafter individually or collectively sometimes called the "insureds") against loss (as hereinafter defined) arising from any claim or claims which are first made against the Insureds, jointly or severally, during the policy period by reason of any Wrongful Act (as hereinafter defined) in their respective capacities as Directors of Officers."

The liability of defendant depends therefore upon proof of the following elements:

1. *loss*

2. arising from any *claim* or claims *first* made against the insureds *during the policy period*

3. by reason of any *wrongful act* in their capacities as directors or officers.

There is sufficient evidence of each element to support a finding of liability for claims made during the first policy year.

LOSS

"Loss" is defined in Paragraph 2 of the policy as follows: The term "Loss" shall mean any amount which

the Insureds are legally obligated to pay for a claim or claims made against them for Wrongful Acts, and shall include damages, judgments, settlements, [et cetera] . . . There are essentially two components of this definition:

1. amounts which insureds are legally obligated to pay

2. for claims made against them for wrongful acts.

The "loss" subject to insurance includes damages, judgments, and settlements.

This coordinated litigation has established the legal obligation of the insureds to pay various amounts for claims made against them for their wrongful acts. Such amounts are embodied in verdicts and findings of damages, in judgments, and in settlements. The amounts attributable to claims made against the insureds during the first policy year exceed $10 million.

Defendant argues that no "loss" occurred during the first policy year, since no director or officer paid money to settle a claim or suffered a judgment during that year. The insuring clause in the policy does not require however that loss occur during a particular policy year, only that loss arise from a *claim first made* against an insured *during the policy period*. In short, the adjudication of the insured's liability may (and often does) occur years after the date upon which a claim is first made against him.

CLAIMS

The policy does not define a claim. The parties agree however that a claim is a demand for money or services.

Williamson & Vollmer Engineering, Inc. v. Sequoia Ins. Co. (1976) 64 Cal.App.3d 261, 269; *Deposition of James Robertson* (National Union Expert), pp. 27:22 – 28:03. Defendant cites various cases for the proposition that a discussion, grievance, or other non-assertive inquiry does not qualify as a claim. The special master's report summarizes the demands made against the insured officers during the first policy year. The court finds that these demands are claims.

WRONGFUL ACTS

The insuring agreement requires that a claim be made against an insured by reason of a wrongful act in his capacity as a director or officer. The term "loss" is also qualified as an amount which the insured is legally obligated to pay for a claim made against him for wrongful acts. The policy defines "wrongful act" as follows:

> "The term "Wrongful Act" shall mean any breach of duty, neglect, error, misstatement, misleading statement, omission or other act done or wrongfully attempted by the Insureds or any of the foregoing so alleged by any claimant or any matter claimed against them solely by reason of their being such Directors or Officers of the Company named in Item 1 of the Declarations. [Emphasis supplied]

The coordinated litigation is replete with evidence of wrongful acts so defined. Such acts created moreover the conditions which caused the various plaintiffs to make their claims during the first policy year.

Each first year claimant was dissatisfied in some manner with the performance of his or her Technical

Equities investment. This dissatisfaction led in turn to a claim made against one or more of the insured T.E. officers. Subsequent envents [*sic*] have shown that poor performance of T.E. investments during the first policy year was the result of the acts and omissions of the insureds. The causal connection between their wrongful acts and the claims is clear.

Defendant contends that the first year demands do not qualify as claims because the plaintiffs did not support their requests for money or services with allegations of wrongful acts by the insureds. As noted in the special master's report, the first year claimants "did not threaten suit, suspect or accuse an officer of misconduct or otherwise allege wrongdoing." Such an allegation would meet the policy definition of a wrongful act. See Paragraph 2(d). A statement of wrongdoing by a claimant is not however a pre-requisite to coverage.

Although the policy may require a causative connection between wrongful acts and a claim, the ability of the claimant to articulate such a connection is not essential. To expect a claimant to do so would be unrealistic, especially in a complex situation such as existed here. The facts of a particular case may become clear only after years of discovery and trial. Requiring a claimant to identify the insured's wrongful acts at the time of the claim would serve no purpose other than tending to defeat coverage in most of the cases for which these policies are written. The court rejects such an interpretation of the policy.

FIRST POLICY YEAR

The first year claims resulted therefore in an insured loss for which defendant is liable. The extent of such liability depends upon the amount of the claims and their attribution to a policy year.

The insuring agreement (Para. 1, Insuring Clause) is silent on the subject of amounts and policy years. The agreement speaks broadly of an undertaking to pay against loss arising from *any* claim *first* made against an insured *during the policy period*. Paragraph 5(b) of the policy form defines the insurer's liability in terms of amount and policy year.

In the actual policy in question, Endorsement 3 amends Paragraph 5(b) to read in part as follows:

> "Subject to the foregoing, the Insurer's liability for any claim or claims made against it shall be the amount stated in Item #3 of the Declarations which shall be the maximum liability of the Insurer in (a) each policy year and in (b) the discovery period, if the right is exercised by the Insureds in accordance with Clause 8(a)."

The amount stated in Item 3 of the Declarations is $10,000,000. Defendant's liability for a particular claim may not therefore exceed $10 million. In addition, this amount is defendant's maximum liability in a policy year.

Each of the first year claims is less than $10 million. In the aggregate, they exceed that amount substantially. See Summary of Claims Made between August 5, 1984 and August 5, 1985. Paragraph 5(b), as amended by Endorsement 3, limits defendant's liability however for such claims to $10 million.

Paragraph 7(a) provides in part:

> "The time when a loss shall be incurred . . . shall be the date on which the Company [Technical Equities Corporation] named in Item 1 of the Declarations or the Insureds shall give written notice to the Insurer . . . "

Strictly applied, this provision might require the attribution of cliams [*sic*] to the policy year in which "the company" or the insureds reported them to the insurer. Defendant urges such an interpretation and also cites Paragraph 7(c) of the policy in support of its position.

The court has already noted the intended consequences of such a facile argument:

> "The use to which National Union, however, puts this proposition shows the subtlety and cleverness of their argument. National Union has treated the Craig Foster letter as a report of the claims of all of the persons who have filed suit in these coordinated proceedings and taken the position that because the report of a claim occurred in the second policy year of the three-year policy period only the sum of ten million dollars is available to pay these claims." Statement of Intended Decision, pp. 34-35

(August 21, 1989). Such a construction of the insurance policy would however make the insurer's undertaking illusory, reducing a three-year, $30 million policy to a single-year, $10 million one. The court rejects this interpretation.

The policy is ambiguous about the attribution of claims to a particular policy year. The insuring agreement simply requires the insurer to pay against loss arising

from any claim first made *during the policy period*. Paragraph 7(c) speaks of *the policy period* and provides that certain claims made after that period shall be treated as claims made *during* the policy period.

For claims made after the policy period, the insurer might well attempt to tie the claim to some event in a particular policy year, attribute the claim to that year, and invoke the limitation of liability protection of Paragraph 5(b). The rule of reason would support such an attempt. The attribution of first year claims to the first policy year in this case should enjoy similar support.

CONCLUSION

In conclusion, defendant['s] liability for claims during the first policy year of the 1984-1987 policy is $10 million. Defendant's request to augment the Special Master's finding "re purported first year claims" to include proposed findings 5 and 6 is denied.

VII. POLICY LIMITS AVAILABLE

The Court need not identify each and every claim, but rather need only determine that claims were in fact made. *Republic Indemnity Co. v. Empire Builders Corp.* (1985) 167 Cal.App.3d 1163; *People v. Convalescent Homes, Inc.* (1984) 159 Cal.App.3d 509.

The Court has taken judicial notice of the hundreds of complaints filed against T.E. officers and directors in the California State Superior and Municipal Courts which are a part of the T.E. Coordinated Proceeding as well as those filed in the California Federal District Court.

Additionally, the Court has taken judicial notice of the hundreds of judgments entered in favor of plaintiffs and hundreds of other T.E. investors in the T.E. Coordinated Proceeding against insureds under the National Union D&O policies.

The Court finds policy coverage of $30 million to pay settlements with and judgments against the insureds, namely T.E. officers and directors.

VIII. COSTS OF DEFENSE

During the trial of this case the Court believed that costs of defense in these coordinated actions were being paid from this Directors and Officers policy. However, in another declaratory relief case, *Chatton v. National Union, et al,* Santa Clara Superior No. 688706, the Court heard testimony, uncontradicted, that some twenty three million dollars in defense costs had been paid from the CGL policy (see this Court's order of February 16, 1990, Chatton v. National Union et al.) and that only the criminal defense costs of Harry Stern and Herbert Barovsky and some other costs, the amount which is unknown to the Court, were "paid" from the Directors and Officers policy. The extent to which allocation of defense costs between policies, as well as the extent to which payment for Directors and Officers costs from the CGL policy moots the findings of the Court on the "self consuming" issues, supra page 6, remains to be seen.

DATED:

/s/ Conrad L. Rushing
Honorable Conrad L. Rushing
Judge of the Superior Court

IN THE SUPERIOR COURT OF THE
STATE OF CALIFORNIA

IN AND FOR THE COUNTY OF SANTA CLARA

COORDINATION PROCEEDINGS MASTER
FILE NO. 1991
SANTA CLARA COUNTY SUPERIOR COURT
NO. 600306
IN RE: TECHNICAL EQUITIES LITIGATION

THIS DOCUMENT RELATES TO:

SC654728 LEONARD HELFAND VS NATIONAL UNION

PROOF OF SERVICE BY MAIL OF:

JUDGMENT

(Filed Aug. 27, 1990)

CLERK'S CERTIFICATE OF MAILING: I certify that I am not a party to this case and that a true copy of this document was mailed first class postage fully prepaid in a sealed envelope addressed as shown below and the document was mailed at SAN JOSE, CALIFORNIA on AUGUST 27, 1990

GRACE K. YAMAKAWA, COUNTY CLERK
/s/
By J. R. FOSTER Deputy

---

1. COTCHETT & ILLSTON, 840 MALCOLM ROAD, STE. 200, BURLINGAME, CA 94010

2. MORGAN, RUBY, ET AL, 99 ALMADEN BLVD., STE. 1000, SAN JOSE, CA 95113

3. THOMAS ANDERSON & ASSOCIATES, 45-926 OASIS STREET, INDIO, CA 92201-4591
4. HELLER, EHRMAN, ET AL, 525 UNIVERSITY AVENUE, STE. 1100, PALO ALTO, 94301
5. COREY, LUZAICH, ET AL, 700 EL CAMINO REAL, P.O. BOX 669, MILLBRAE, 94030
6. THELEN, ET AL, TWO EMBARCADERO CENTER, #2100, SAN FRANCISCO, CA 94111
7. PETTIT & MARTIN, 101 CALIFORNIA STREET, 35TH FLOOR, SAN FRANCISCO, 94111

First Appellate District, Division Four, No. A049442
S030106

IN THE SUPREME COURT OF THE
STATE OF CALIFORNIA

IN BANK

LEONARD HELFAND Et Al., Respondents

v.

NATIONAL UNION FIRE INSURANCE CO. OF PITTSBURGH PA, Appellant

(Filed Feb. 11, 1993)

Appellant's petition for review DENIED.

Panelli, J. is of the opinion the petition should be granted.

Lucas
Chief Justice

COURT OF APPEAL OF THE STATE OF CALIFORNIA
IN AND FOR THE FIRST APPELLATE DISTRICT
DIVISION: 4

HELFAND, LEONARD ET AL.
vs.
NATIONAL UNION FIRE INS. CO., ETC.
TECHNICAL EQUITIES LITIGATION #1991
A049442 Old No. A049438
Santa Clara County No. 1991

(Filed Nov. 30, 1992)

BY THE COURT:

The petition for rehearing is denied.

Dated: NOV 30 1992

ANDERSON, P.J.

EXCERPTS FROM

TRIAL BRIEF OF NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.

Trial Date: May 22, 1989

(Filed May 12, 1989)

* * *

C. Prior To The Inception Of Policy Year III Of The D&O Policy, There Was A Consensual Cancellation Of The D&O Policy Which Was Approved By The United States Bankruptcy Court.

Policy Year III of the D&O Policy is not an issue in this case. Plaintiffs cannot – as a matter of law – base any claim upon Policy Year III of the D&O Policy. This is so because there was an agreed upon cancellation of the D&O Policy between National Union and TEC, which cancellation was approved by order of the United States Bankruptcy Court for the Northern District of California. Further, the D&O Policy was cancelled prior to the inception of Policy Year III. As discussed herein, TEC elected the extended discovery period with respect to Policy Year II, a provision that attached to Policy Year II.

Any claim based on Policy Year III constitutes an impermissible collateral attack on a prior order of the Bankruptcy Court and is barred by the doctrine of *res judicata*. The order of the United States Bankruptcy Court states, among other things:

> Adequate notice of the Motion and the hearing was provided to all parties entitled thereto. . . . The compromise described in the Motion,

> including cancellation of the [D&O] Policy subject to the issuance of the Successor Policy, is approved as being in the best interest of the estate and creditors.

Plaintiffs' attempt to establish coverage under Policy Year III of the D&O Policy constitutes an impermissible collateral attack on this prior order of the Bankruptcy Court.[7] A judgment or order is not subject to collateral attack "unless it is absolutely void, and it is not void unless made or entered without authority of law, or, as usually stated, without jurisdiction. . . . In such attack the invalidity of the former judgment or order must appear on the face of the record." *Rico v. Nasser Brothers Realty Co.*, 58 Cal. App. 2d 878, 882 (1943).

California courts have protected bankruptcy court orders approving compromises from collateral attack. For example, in *Heffron v. Rosenberg*, 51 Cal. App. 2d 156 (1942), the court overturned a trial court order appointing a receiver of certain assets held by a third party which were alleged by a trustee and a debtor to be partially

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[7] A collateral attack is an attempt to avoid the effect of a judgment or order made in some other proceeding.

> A collateral attack is indirect. It is made, not in a proceeding brought for the specific purpose of attacking the judgment . . . but *in some other proceeding having a different purpose*. . . . In a direct attack, the judgment is *reviewed* for error, including jurisdictional defects. In a collateral attack, the judgment comes up only incidentally, and may be effectively challenged only if it is so completely invalid as to require no ordinary review to annul it.

8 B. E. Witkin, *California Procedure: Attack on Judgment in Trial Court*, § 6 at 410 (3d ed. 1985) (emphasis in original).

owned by the debtor. The court found that the claim raised by the trustee and the debtor had been fully settled and compromised in bankruptcy court:

> That order having the effect of a judgment of a judicial tribunal must now be deemed a final adjudication of the bankrupt's interests in the property involved in this litigation . . . . *The remedy of the bankrupt was by appeal or other direct attack to review the order and the remedy lies in the bankruptcy court. The order was not subject to this collateral attack in the state court.*

Id. at 160 (emphasis added).

Similarly, in *Mueller v. Elba Oil Co.*, 21 Cal. 2d 188 (1942), the California Supreme Court ruled that where a bankruptcy court had jurisdiction over the parties, the plaintiff creditor had notice of the compromise proceeding, and there was no allegation of fraud, there could be no collateral attack on a bankruptcy court order approving a compromise. *Id.* at 205:

> Where the judgment or decree of the Federal Court determines a right under a Federal statute, that decision "is final until reversed in an appellate court or modified or set aside in the court of its rendition."

Id. at 205 (quoting *Stoll v. Gottlieb*, 305 U.S. 165, 170 (1938)). The court also noted:

> Perhaps upon appeal, or other form of review in the federal courts, it might have been held that the referee's order of compromise and release was erroneous . . . but *the state court is not a court of review for proceedings in the federal bankruptcy court.*

Id. at 207 (emphasis added). *See also Martin v. Martin*, 2 Cal. 3d 752, 762 (1970) (order of bankruptcy court may only be challenged by way of direct attack in the federal court).

Plaintiffs cannot raise any issue in this Court with respect to coverage under Policy Year III of the D&O Policy. The plaintiffs have contended that the cancellation of the D&O Policy is not effective *as to them*. In fact, the cancellation of the D&O Policy is effective as to everybody, especially in light of the order of the Bankruptcy Court. Moreover, as set forth above, the plaintiffs do not have a right to litigate in this Court the effectiveness of an order of the United States Bankruptcy Court.

If plaintiffs believe that the agreed upon cancellation of the D&O Policy was somehow improper, plaintiffs' remedy, if any, is found in Federal Rule of Civil Procedure 60(b), as incorporated by Rule 9024 of the Bankruptcy Rules, which sets forth the procedure for obtaining relief from a final judgment, order, or proceeding of a Federal Court. Plaintiffs have chosen to ignore that procedure and attempt to challenge a prior order of the Bankruptcy Court in this Court. That attempt constitutes an impermissible collateral attack on a prior order of the Bankruptcy Court and an unwarranted interference with the jurisdiction and lawful orders of that Court.[8]

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[8] In fact, the conduct of the plaintiffs in attempting to attack a prior order of the Bankruptcy Court is precisely the type of conduct that may be enjoined by the federal court that issued the prior order. Specifically, 28 U.S.C. § 2283 provides that an exception to the Federal Anti-Injunction Act applies "where necessary in aid of [the Federal Court's] jurisdiction or to protect or effectuate its judgments." 28 U.S.C. § 2283.

A further, independent bar to any question that the D&O Policy was not cancelled prior to Policy Year III of the D&O Policy is the doctrine of *res judicata* which prevents these plaintiffs from relitigating the issue of the cancellation of the D&O Policy. In their interrogatory responses, plaintiffs contend that the order of the Bankruptcy Court approving the consensual cancellation of the D&O Policy is not binding on them, and those who did not receive notice of the motion, were not parties to the bankruptcy proceeding, and did not appear at the hearing before the Bankruptcy Court. These contentions lack legal significance.

The D&O Policy was cancelled pursuant to the explicit terms and conditions of the D&O Policy, by giving notice to TEC pursuant to Paragraph 8(b) of the D&O Policy. The cancellation of the D&O Policy fully complied with this Cancellation Clause of the D&O Policy, which provides both the insured and National Union with a contractual right of cancellation.[9] In addition, the cancellation conformed with the customs and practice of the insurance industry. The D&O Policy does not require notice to be given to all third party claimants and potential claimants. The named insured under the D&O Policy is TEC who purchased the premium for its director and

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[9] The notice provisions of the D&O Policy, Paragraph 10, also provides as follows:

> By acceptance of this policy, the Company named in item 1 of the Declarations agrees to act on behalf of all insureds with respect to the giving and receiving of notice of claim or cancellation, the payment of premiums and the receiving of any return premiums that may become due under this policy.

officers. If TEC and its directors and officers are barred from relitigating any issues relating to the cancellation of the D&O Policy, then plaintiffs are also bound, because Leonard and Eileen Helfand can have no greater rights, as assignees, than the insureds. It is well-established that

> [t]he doctrine of res judicata precludes parties or their privies from relitigating a cause of action that has been finally determined by a court of competent jurisdiction. Any issue necessarily decided in such litigation is conclusively determined as to the parties or their privies if it is involved in a subsequent lawsuits on a different cause of action.

Martin v. Martin, 2 Cal. 3d at 758 (1970) (quoting *Bernhard v. Bank of America*, 19 Cal. 2d 807, 810 (1942)). In this case, the Bankruptcy Court approved the agreed upon cancellation of the D&O Policy. All of the directors and officers of TEC are bound by that order. Therefore, these plaintiffs, as alleged assignees, are also bound by that order.

Even assuming the plaintiffs in this action, Leonard and Eileen Helfand, have an independent right as third-party claimants to challenge the validity of the agreed upon cancellation of the D&O Policy, relitigation of any issue regarding that cancellation is also barred by *res judicata*. This is so because the order of the Bankruptcy Court is binding on all "parties or their privies." *Martin*, 2 Cal. 3d at 758. Here, plaintiffs were in privity with other parties who did participate in the bankruptcy hearing.[10]

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[10] The order of the Bankruptcy Court states that counsel for several plaintiffs in the underlying actions, including Security

Privity exists where: (1) the non-party had an identity of interest with, and adequate representation by the losing party in the first action; and (2) the non-party should reasonably have expected to be bound by the prior adjudication. *Frazier v. City of Richmond,* 184 Cal. App. 3d 1491, 1498-99 (1986) (judgment in prior class action held res judicata as to non-parties). A non-party should reasonably expect to be bound by a prior adjudication when a party in the prior action can fairly be treated as actions in a representative capacity for the non-party. *Lynch v. Glass,* 44 Cal. App. 3d 943, 949 (1975).

Under this test, Leonard and Eileen Helfand are in privity with those plaintiffs in the underlying actions who did participate in the bankruptcy proceeding. The interest of the Helfands in challenging the validity of the agreed upon cancellation of the D&O policy is identical to the interest of those plaintiffs who participated in the bankruptcy proceeding. Furthermore, the community of interest is so strong between plaintiffs and the participants in the bankruptcy hearing that such participants can fairly be considered to have acted in a representative capacity. *See e.g., King v. International Union of Operating Engineers,* 114 Cal. App. 2d 159, 164 (1952) (action against union by union members held barred by *res judicata* where other union members had previously lost an identical claim against union and court found that prior action was on behalf of all union members.) This is especially so in this case where counsel who purported to represent a class of plaintiffs in the underlying actions

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Pacific National Bank, Bank of the West, and the class plaintiffs, appeared at the hearing.

participated in and attended the hearing in Bankruptcy Court. For all of these reasons, plaintiffs cannot assert an independent right to challenge the validity of the cancellation of the D&O Policy, because of the doctrine of *res judicata*.

* * *

EXCERPTS FROM LETTER FROM NATIONAL UNION'S COUNSEL TO SUPERIOR COURT JUDGE CONRAD RUSHING

PETTIT & MARTIN
ATTORNEYS AT LAW
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

101 CALIFORNIA STREET

SAN FRANCISCO, CALIFORNIA 94111

June 9, 1989

Via Messenger

The Honorable Conrad Rushing
Judge of the Superior Court
191 North First Street
San Jose, CA 95113

Re: *Helfand v. National Union, et al.*

Dear Judge Rushing:

We are writing on behalf of National Union Fire Insurance Company of Pittsburgh, Pa. ("National Union") in response to the letter dated May 30, 1989 from Seymour J. Abrahams, which addresses certain of the issues in *Helfand v. National Union*. That letter should not be considered by this Court because all of the arguments contained therein constitute an impermissible collateral attack on a prior order of the United States Bankruptcy Court. As National Union has repeatedly argued before this Court, "the state court is not a court of review for proceedings in the federal bankruptcy court." *Mueller v. Elba Oil Co.*, 21 Cal.2d 188, 207 (1942). The United States Bankruptcy Court approved the compromise that was presented to that Court, including the cancellation of the

Directors and Officers Liability and Corporation Reimbursement Policy (the "D&O Policy") issued by National Union to Technical Equities Corporation, "as being in the best interest of the estate and creditors." If Paul Kouns, or any other party, contends that this order is somehow improper, the remedy of that party, if any, is by appeal or other direct attack in the Bankruptcy Court. *See Heffron v. Rosenberg*, 51 Cal.App.2d 156, 160 (1942). Accordingly, this Court is not the appropriate forum in which to address the issues raised by Mr. Abrahams' letter.[1]

With respect to the arguments raised by Mr. Abrahams regarding the collateral estoppel or *res judicata* effect of the order of the United States Bankruptcy Court, today we filed a Petition for Writ of Mandate, Prohibition or Other Appropriate Relief regarding this Court's overruling of National Union's demurrers and motions to strike that were filed in the bad faith actions brought against National Union. A copy of that Petition is enclosed for the Court's reference.

* * *

The issue of the cancellation of the D&O Policy, as raised in the bad faith actions, overlaps the issues raised in *Helfand v. National Union* which are addressed in Mr. Abrahams' letter. Therefore, this letter will not repeat the

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[1] [Footnote omitted.]

arguments made in the Petition, which fully explains National Union's position regarding those issues.

* * *

Respectfully yours,

PETTIT & MARTIN

Saul D. Bercovitch

EXCERPTS FROM

PETITION FOR WRIT OF MANDATE, PROHIBITION, OR OTHER APPROPRIATE RELIEF; MEMORANDUM OF POINTS AND AUTHORITIES

Filed concurrently with letter of June 9, 1989
From Pettit & Martin to Judge Rushing

* * *

California decisions have consistently refused to allow collateral state court attack on federal bankruptcy court orders and judgments. *See,* for example, *Martin v. Martin,* 2 Cal. 3d 752, 762 (1970), in which the California Supreme Court emphatically stated that bankruptcy orders "can be . . . challenged solely by way of direct attack in the federal court" and "may not be collaterally attacked in the instant state proceeding," holding a dischargeability order to be res judicata.

Significantly, this rule has been applied particularly when bankruptcy court orders approving compromises have been collaterally challenged. In *Mueller v. Elba Oil Co.,* 21 Cal. 2d 188 (1942), the California Supreme Court ruled that when a bankruptcy court had jurisdiction over the parties and the plaintiff's assignor (as here) had notice of the compromise proceeding, there could be no collateral attack on a bankruptcy court order approving a compromise. Noting that California's courts give full faith and credit to final judgments and orders of federal courts, the Court concluded:

> [W]here the judgment or decree of the Federal Court determines a right under a Federal statute, that decision "is final until reversed in an

> appellate court or modified or set aside in the court of its rendition."

Id. at 205 (quoting *Stoll v. Gottlieb*, 305 U.S. 165, 170 (1938)). The Court also noted:

> Perhaps upon appeal, or other form of review in the federal courts, it might have been held that the referee's order of compromise and release was erroneous . . . but *the state court is not a court of review for proceedings in the federal bankruptcy court.*

Id. at 207 (emphasis added).

Similarly, in *Heffron v. Rosenberg*, 51 Cal. App. 2d 156 (1942), the Court overturned a trial court order appointing a receiver as to certain assets held by a third party which, the trustee and debtor claimed, were partially owned by the debtor. The Court found that the claim raised by the trustee and the debtor had been fully settled and compromised in bankruptcy court:

> That order having the effect of a judgment of a judicial tribunal must now be deemed a final adjudication of the bankrupt's interests in the property involved in this litigation. . . . *The remedy of the bankrupt was by appeal or other direct attack to review the order and the remedy lies in the bankruptcy court. The order was not subject to this collateral attack in the state court.*

Id. at 160 (emphasis added).[15]

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[15] *See also, Gonzales v. Parks*, 830 F.2d 1033, 1035 (9th Cir. 1987) (holding that state courts do not have subject matter jurisdiction to hear collateral attacks on bankruptcy petitions).

Moreover, as the California Supreme Court noted in *Levy v. Cohen*, 19 Cal. 3d 165, 172 (1977), an "arrangement confirmed by a bankruptcy court has the effect of a judgment rendered by a federal district court." The *Levy* Court held that given full faith and credit, federal orders and judgments have "the same effect in the courts of this state as [they] would have in a federal court," and that a federal "judgment or order, once rendered, is final for purposes of res judicata until reversed on appeal or modified, or set aside in the court of rendition" (also citing *Stoll v. Gottlieb, supra*).

* * *

V. RESPONDENT COURT ABUSED ITS DISCRETION BY HOLDING THAT REAL PARTIES ARE NOT BOUND BY THE BANKRUPTCY COURT ORDER AS A MATTER OF LAW

In overruling Petitioner's demurrers to the third and seventh causes of action, Respondent Court opined that the "effect" of the Bankruptcy Court Order "involves questions of fact" – issues of fact which respondent Court left unidentified.[18] In so ruling, Respondent Court ignored the nature of the TEC Bankruptcy Action and the Bankruptcy Court's jurisdiction, as well as the controlling principle of res judicata. By doing so, Respondent Court fatally erred, necessitating mandamus or other extraordinary relief to compel that Respondent Court's Order be vacated.

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[18] The Respondent Court's cursory May 4 Order disposed of Petitioner's demurrers, and the significant issues raised thereby, in one terse sentence.

Notwithstanding the express authority over and jurisdiction as to the D&O Policy itself possessed by the Bankruptcy Court in the Bankruptcy Action (*see e.g.*, pp. 32-37, *infra*), Real Parties contend that they somehow have the right to interfere with that authority and jurisdiction (and thus, TEC's reorganization efforts) by seeking a state court determination that the Bankruptcy Court Order was "wrongful." Respondent Court's Order, unfortunately, only furthers Real Parties' baseless contention. Both Real Parties and Respondent Court are in error, for Real Parties are fully bound by the Bankruptcy Court Order and have no right to pursue their third and seventh causes of action, whether as assignees or as third-party claimants with allegedly independent "rights" in the D&O Policy.[19] A review of the Bankruptcy Court's authority and power in this respect makes this clear.

A. The Nature Of The Bankruptcy Court's Powers And Jurisdiction Mandates That Real Parties Be Bound By The 1986 Bankruptcy Court Order.

Fundamentally, federal "[p]roceedings in bankruptcy are proceedings in rem and all persons concerned, including creditors, are deemed to be parties to the proceedings." *Levy v. Cohen, supra,* 19 Cal. 3d at 172. In accord:

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[19] As noted *supra,* Real Parties have pleaded their third and seventh causes of action based solely on their alleged status as *assignees* of those former TEC directors and/or officers who were covered by the D&O Policy. Although nowhere alleged in their amended Complaints, in later argument of counsel (*i.e.,* Exhibit 5 to the Petition), Real Parties belatedly asserted a separate purported ground for these two claims – namely, their purported third-party "rights" under the D&O Policy.

Miller v. R.K.A. Management Corp., supra, 99 Cal. App. 3d at 468. "Upon commencement of a bankruptcy proceeding the bankruptcy court obtains jurisdiction over the estate of the debtor." *Wilson v. Bill Barry Enterprises, Inc.*, 822 F.2d 859, 861 (9th Cir. 1987) (citing *Callaway v. Benton*, 336 U.S. 132, 142-143 (1949)). *See also, MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 91 (2d Cir. 1988) (noting it "is well established that a bankruptcy court has jurisdiction over all of the property of the debtor's estate, wherever located"). It is equally well settled that "a debtor's insurance policies are property of the estate, subject to the bankruptcy court's jurisdiction." *Id.* at 92.[20]

Thus, the contractual rights under the D&O Policy itself were in 1986, and remain today, "property" of the TEC "estate" by virtue of the TEC Bankruptcy Action and thus within the exclusive jurisdiction of the United States Bankruptcy Court for the Northern District of California. As the Court noted in *Miller v. R.K.A. Management Corp., supra,* 99 Cal. App. 3d at 466: "So that the debtor's estate may be properly administered and the rights of creditors safeguarded, state courts may not intrude on the bankruptcy court's exclusive jurisdiction."[21]

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[20] *See also, In re Minoco Group of Companies, Ltd.*, 799 F.2d 517, 519 (9th Cir. 1986) (directors and officers liability insurance policy found to be "property of the estate" and subject to the bankruptcy court's jurisdiction); *Tringali v. Hathaway Machinery Co., Inc.*, 796 F.2d 553, 560 (1st Cir. 1986); and *A.H. Robins Co., Inc. v. Piccinin*, 788 F.2d 994, 1001 (4th Cir. 1986), *cert. denied*, 107 S.Ct. 251 (1986).

[21] Thus, the very fact of the prior Federal Interpleader Action concerning the D&O Policy, now pending before the Bankruptcy Court, in and of itself is sufficient to prohibit

The bankruptcy court also possesses the express authority and discretionary power to approve compromises as to claims and interests involved in reorganization proceedings, "and its judgment will not be reversed except for abuse of discretion or if clearly erroneous." *American Emp. Ins. Co. v. King Resources Co.*, 556 F.2d 471, 478 (10th Cir. 1977) (and citations therein). *See also*, Bankr. Rule 9019, 11 U.S.C.A. Indeed, "[a] compromise effected with the approval of the court is conclusive on the parties and on the creditors of the estate as well." 9 *Collier on Bankruptcy* (15th Ed.), ¶ 9019.03, p. 9019-5 (1988).

For example, in *MacArthur Co. v. Johns-Manville Corp., supra*, 837 F.2d at 92-93, a bankruptcy court order settling the debtor's claims against its product liability insurers and going so far as to enjoin any further third-party suits against the insurers (relating to the settled policies) was affirmed. The Court noted that any insurance "rights" of the plaintiff (a distributor of the debtor's products) were "completely derivative" of the debtor's rights as the "primary insured," as were the claimed rights of third-party tort claimants, and that in both instances, the claims were

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Respondent Court's assertion of jurisdiction over the third and seventh causes of action. Moreover, the Bankruptcy Court, in response to Real Parties' motion, already expressly has determined that it has jurisdiction to distribute the D&O Policy proceeds and will not defer to Respondent Court. *See, e.g., Miller, supra,* (affirming the sustaining of demurrer to state action brought by officers and directors of debtor involved in reorganization/bankruptcy proceedings, by which plaintiffs sought to set aside a bankruptcy court-approved sale of the debtor's property, concluding that "[j]urisdiction in the state court over plaintiffs' action is specific [sic] and clearly precluded by express federal statute and case authority." 99 Cal. App. 3d at 465.

"inseparable" from the debtor's insurance coverage and were "well within" the bankruptcy court's jurisdiction over the debtor's assets. The Second Circuit concluded that the bankruptcy court's settlement and injunction orders were a proper exercise of its "channeling authority" – *i.e.*, to approve insurance settlements and to channel claims arising under the policies to the settlement proceeds. *Id.* at 93.

> The Bankruptcy Court properly issued the orders pursuant to its equitable and statutory powers to dispose of the debtor's property free and clear of third-party interests and to channel those interests to the proceeds thereby created.

Id. at 91. Similarly here, the Bankruptcy Court Order and the Federal Interpleader Action represent lawful exercises of the Bankruptcy Court's sole authority to dispose of, or approve of compromises as to, the D&O Policy and to "channel" third-party claims.

Fundamentally, on a day-to-day basis, bankruptcy courts issue orders which affect the property and rights of third parties. They marshall assets, obtain the turnover and return of transferred property, they use, lease and sell property in which the debtor may own only a partial interest, and they discharge valid debts, among other things – all in aid of reorganization and liquidation efforts for insolvent persons and entities. Many actions which may seem unfairly to favor debtors, at least from third parties' and creditors' perspectives, are expressly allowable under the bankruptcy system.

For example, in *Matter of Gregory*, 705 F.2d 1118 (9th Cir. 1983), an unsecured creditor received a bankruptcy

court notice of a creditors' meeting and confirmation hearing and that the debtor's plan did not provide for payment to unsecured creditors. A copy of the plan was not included. Plaintiff did not attend the meeting or confirmation hearing, and the debtor's plan was confirmed. Plaintiff then filed a separate action to protest the dischargeability of the debt owed to him. The Ninth Circuit, although noting that discharge might seem "grossly unfair," upheld the total discharge of the debt, concluding that having failed to object to the confirmation of the debtor's plan, plaintiff was "precluded from raising that objection in subsequent proceedings."

> When the holder of a large, unsecured claim such as [plaintiff] receives any notice from the bankruptcy court that its debtor has initiated bankruptcy proceedings, it is under constructive or inquiry notice that its claim may be affected, and it ignores the proceedings to which the notice refers at its peril.

Id. at 1123. *See also, Levy v. Cohen, supra,* 19 Cal. 3d at 174 (reaching similar conclusions and result).

As in *Gregory,* Real Parties here had actual and constructive notice of the initiation of the TEC Bankruptcy Action *and* the July 28, 1986 Hearing.[22] They ignored that proceeding at their "peril." The Bankruptcy Court Order and the present situation likewise represent nothing more

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[22] Petitioner submits that Real Parties' notice of the TEC Bankruptcy Action alone is sufficient to defeat their third and seventh causes of action, but need not rely on that fact alone, since it is clear that Real Parties likewise had constructive (indeed, at least one, if not more, had actual) notice of the July 28 Hearing.

than a bankruptcy court's proper exercise of its (1) exclusive jurisdiction over a debtor's estate and (2) authority to approve settlements and dispose of the debtor's property free and clear of "completely derivative" third-party interests, even when to do so "channels" derivative insurance claims. No matter how much Real Parties may try to avoid the res judicata effect of the Bankruptcy Court Order, its conclusive and preemptive effect is undeniable. Real Parties are bound thereby.

B. Res Judicata Bars Real Parties' Purported "Assignee" Claims.

As shown above, the nature of the Bankruptcy Court's jurisdiction expressly allows for binding orders, such as the Bankruptcy Court Order in issue here, and Real Parties' arguments as to purported assignee or third party claimant rights in the D&O Policy do not change this fact. It is well settled that an assignee "stands in the shoes of his assignor" – namely, an assignee can acquire no greater right than that possessed by his assignor, and takes subject to all equities and defenses then existing in favor of any obligor. *See, e.g., Salaman v. Bolt*, 74 Cal. App. 3d 907, 919 (1977). This rule applies with equal force in the context of the assignment by an insured of its rights against an insurer to a third party. *Doser v. Middlesex Mut. Ins. Co.*, 101 Cal. App. 3d 883, 890 (1980) (noting that a valid cause of action must exist in the assignor-insured before its assignee could prevail against the insurer); *see also, Woolett v. American Emp. Ins. Co.*, 77 Cal. App. 3d 619, 625 (1978).

Thus, if Real Parties' assignors (*viz.*, the former TEC directors and officers) do not have any valid cause of action against Petitioner for purported "wrongful cancellation" of the D&O Policy, neither can Real Parties as assignees. In other words, if the former TEC directors and officers *are bound* by the 1986 Bankruptcy Court Order, then so are Real Parties to the extent that their two causes of action are founded on Real Parties' assignee status, as they have expressly pleaded.

Respondent Court, by its Order, took judicial notice of the Notice of Hearing which preceded the Bankruptcy Court Order. The Notice of Hearing was served on TEC directors and officers, either individually (for the most part) or in some instances on their counsel of record.[23] The Notice of Hearing clearly spelled out the compromise and agreed-upon D&O Policy Cancellation, and the need for any interested party to make any objections promptly.

Given that all assignor-TEC officers and directors received *actual notice* of the July 28, 1986 Hearing on the proposed compromise and cancellation of the D&O Policy and were given a full opportunity to file objections and appear at the Bankruptcy Court Hearing, they are bound by the Bankruptcy Court Order approving that

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[23] Real Parties have argued that one of the TEC directors (Paul Knauff) was not served with the Notice of Hearing. Real Parties' assertion is incorrect. The Notice of Hearing was served on counsel for all of the Outside Directors of TEC, which included Mr. Knauff. Even if, *arguendo*, Mr. Knauff had not received the notice he did, he clearly was in privity with the other TEC directors and officers who received notice and is bound thereby. (Citation omitted).

compromise and cancellation, for that Order is res judicata as to them. In *Chicot County Drainage Dist. v. Baxter State Bank*, 308 U.S. 371 (1940), the United States Supreme Court held that res judicata precluded certain bondholders, who had received direct notice of a debtor's reorganization proceeding but who did not raise any objections, from pursuing a separate later federal court action to recover on bonds issued by the debtor. The Court concluded:

> The remaining question is simply whether respondents having failed to raise the question in the proceeding to which they were parties and in which they could have raised it and had it finally determined, were privileged to remain quiet and raise it in a subsequent suit. Such a view is contrary to the well-settled principle that res judicata may be pleaded as a bar, not only as respects matters actually presented to sustain or defeat the right asserted in the earlier proceeding, "but also as respects any other available matter which might have been presented to that end [cit. om.]."

Id. at 378. The Court concluded that the bondholders, having received notice and thus the opportunity to object to the debtor's reorganization, were "not the less bound" by the bankruptcy court's order thereon because they failed to appear and object. *Id.* at 375. In accord: *Levy v. Cohen, supra*, 19 Cal. 3d at 174.[24] *See also, Interinsurance Exchange of the Auto. Club v. Superior Court*, 209 Cal. App. 3d 177 (1989), in which the Court granted a mandamus

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[24] [Footnote omitted].

petition brought from an order overruling a demurrer (which was premised on a claim that the underlying action was barred by collateral estoppel). The Court, quoting from *Sutphin v. Speik*, 15 Cal. 2d 195, 202 (1940), concluded that the following rule governs as to whether an issue is "res judicata":

> Next is the question, under what circumstances is a matter to be deemed decided by the prior judgment? Obviously, if it is actually raised by proper pleadings and treated as an issue in the cause, it is conclusively determined by the first judgment. But the rule goes further. *If the matter was within the scope of the action, related to the subject-matter and relevant to the issues, so that it could have been raised, the judgment [sic] is conclusive on it despite the fact that it was not in fact expressly pleaded or otherwise urged.* The reason for this is manifest. A party cannot by negligence or design withhold issues and litigate them in consecutive actions. Hence the rule is that the prior judgment is *res judicata* on matters which were raised or could have been raised, on matters litigated or litigable . . .

Id. at 182 (emphasis in original).

The assignor-TEC directors and officers were not "privileged to remain quiet" with respect to the 1986 Bankruptcy Court hearing on the compromise and D&O Policy cancellation in the TEC Bankruptcy Action and thereafter raise purported objections almost three years later in a different forum, either by themselves or through assignee/proxies. Given that Real Parties "stand in the shoes" of those former TEC directors and officers, they too, as assignees, are barred by reason of res judicata

from raising and relitigating the issue of the validity of the D&O Policy Cancellation. Given that Real Parties' third and seventh causes of action are predicated solely on Real Parties' status as such assignees, Respondent Court therefore committed manifest error in ignoring the applicability of res judicata here and in failing to sustain Petitioner's demurrers.

C. Res Judicata Also Bars Real Parties' Purported "Third Party Rights" Claims.

Real Parties maintained in their opposition papers filed in Respondent Court that res judicata was not applicable to the third and seventh causes of action because Real Parties had independent "rights" in the D&O Policy as third party claimants which could not have been "cut off" without notice to them and that they did not receive notice as to the July 28, 1986 Bankruptcy Court hearing.[25] Real Parties' contention in this respect is untenable for any number of reasons, including, most significantly, that Real Parties *did* receive both actual and constructive notice of, and were represented at, the July 28, 1986 Hearing by operation of applicable principles of privity (discussed below), that Real Parties' contention misunderstands and contravenes the nature of bankruptcy proceedings (discussed *supra*, pp. 32-36), and that Real Parties misunderstand the nature of claims-made

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[25] Significantly, Real Parties did not plead any allegations in this respect and the after-the-fact argument of their counsel as to this theory is not a substitute for defective pleading nor is it sufficient to prevent the sustaining of Petitioner's demurrers.

policies and did not have any such independent third party "rights" (discussed *infra*, pp. 47-52).

Even if it could be assumed, *arguendo* (which Petitioner does not concede), that Real Parties somehow had the "right" as third-party claimants to challenge the validity of the court-approved cancellation of the D&O Policy, relitigation of that issue by Real Parties in their status as third-party claimants is as barred by res judicata as it is in their status as assignees. This is so because the Bankruptcy Court Order is binding on all "parties or their privies." *Martin, supra*, 2 Cal. 3d at 758.[26] Moreover, Real Parties were in privity with other parties who did participate in the July 28, 1986 Hearing.

Privity exists where: (1) the non-party had an identity of interest with, and adequate representation by, the losing party in the first action; and (2) the non-party should reasonably have expected to be bound by the prior adjudication. *Frazier v. City of Richmond*, 184 Cal. App. 3d 1491, 1498-99 (1986) (judgment in prior class action held res judicata as to non-parties). A person not a party to a prior adjudication may be bound by that prior adjudication when a party thereto fairly can be treated as acting in a representative capacity for the non-party. *See, e.g., Armstrong v. Armstrong, supra*, 15 Cal. 3d at 951; *Sartor v. Superior Court*, 136 Cal. App. 3d 322, 328 (1982);

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[26] Here, at least one of the Real Parties (Heller Financial, Inc.) received direct and actual notice of the upcoming July 28, 1986 Bankruptcy Court hearing, through service on its counsel, but nevertheless failed to appear or otherwise make any objection. See Exhibit E to Exhibit 22 to the Petition. As such, it is bound by res judicata. *Levy v. Cohen, supra*, 19 Cal. 3d at 174.

and *Columbus Line, Inc. v. Grey Line Sight-Seeing Companies Associated, Inc.*, 120 Cal. App. 3d 622, 629-631 (1981).

As shown *supra*, counsel for the Federal Plaintiff Class received actual notice of and appeared at the July 28, 1986 Bankruptcy Court hearing on the compromise and cancellation of the D&O Policy.[27] That counsel, of course, as the representative of a purported class which presumptively included Real Parties, owed fiduciary duties to Real Parties. *See, e.g., Gill v. Monroe County Dept. of Social Services*, 92 F.R.D. 14, 17 (W.D. N.Y. 1981) (holding that at all times during a class action, including from its filing, "the class attorney has a fiduciary duty to the absent class members").[28] Indeed, had Real Parties not *later* chosen to opt out of the Federal Class Action once it was certified, they clearly would be bound by their then class action counsel's notice of an appearance at the July 28 hearing, and now could not be heard to claim lack of

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[27] Mr. Donaldson noted at that hearing that he was appearing in connection with another matter in the TEC Bankruptcy Action, but his disclaimer did not avoid the fact that he had received direct notice on behalf of the Federal Plaintiff Class and had appeared. Real Parties thus actually were "present" and represented at the July 28 hearing. That Real Parties later chose to opt out of that federal class action does not change the fact that at the time of the Bankruptcy Court Order, they were members of the claimed class encompassed within the Federal Plaintiff Class, and their counsel appeared and did not object at that hearing.

[28] When there is an identity of interests, a non-party may be collaterally estopped if the litigating party acted in a fiduciary capacity for a non-party. *Moldovan v. Great Atlantic & Pacific Tea Co., Inc.*, 790 F.2d 894, 899 (3d Cir. 1986), *cert. denied*, 108 S. Ct. 1074 (1988).

notice or representation. Since, however, Real Parties presumptively were within the class definition of the purported class sought to be certified in the Federal Plaintiff Class at that time and were represented at the hearing, at the very least, they are bound by the Bankruptcy Court Order by reason of privity. *See, e.g., Armstrong v. Armstrong, supra,* 15 Cal. 3d at 951 ("privity exists where the person involved is . . . 'so identified in interest with another that he represents the same legal right' ").

Additionally, the Unsecured Creditors' Committee in the TEC Bankruptcy Action also received the July 8, 1986 Notice of Hearing and was represented by counsel at the July 28, 1986 Bankruptcy Court Hearing.[29] The Unsecured Creditors' Committee not only did not object to the proposed compromise and D&O Policy cancellation prior to or at the time of the July 28 Bankruptcy Court hearing, but actually signed off as "approved" on Judge King's Order approving the compromise and cancellation.[30] As did counsel for the Federal Plaintiff Class, any member of the Unsecured Creditors' Committee "undertakes to act in a fiduciary capacity on behalf of the members of the class he represents." *In re Johns-Manville Corp.,* 26 B.R. 919, 924 (S.D.N.Y. 1983).

Clearly, Real Parties were unsecured "creditors" or TEC's estate when the TEC Bankruptcy Action was

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[29] *See* Exhibit E to Exhibit 22 to the Petition (Notice of Hearing) and Exhibit 24 to the Petition (Hearing Transcript).

[30] Exhibit F to Exhibit 4 to the Petition.

commenced[31] and thus, were represented, as a matter of law, by the members of the Unsecured Creditors' Committee in connection with that Committees's notice of, and appearance at, the July 28, 1986 Bankruptcy Court Hearing. Given the fiduciary relationship which existed between them, Real Parties and that Committee were in privity, and Real Parties are as bound by the Bankruptcy Court Order as the Unsecured Creditors' Committee.

For example, in *In re Dominelli*, 820 F.2d 313 (9th Cir. 1987), a junior lienholder as to property owned by a bankruptcy debtor was held to be barred by res judicata from bringing suit to object to a senior lien (on the ground that the underlying loan was usurious) when the bankruptcy trustee already had brought and settled, with bankruptcy court approval, a usury claim against the senior lienholder. The Ninth Circuit concluded that res judicata applied because the junior lienholder and trustee were in privity on the usury issue, and that the trustee is "the optimal party in interest to raise objections on behalf of the estate" and that "the trustee's action challenging one creditor's claim preempts another creditor's right to object." *Id.* at 317.[32]

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[31] *See* Section 101(9)(A) of the Bankruptcy Code (" 'creditor' means – entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor"). Section 101(4) of the Bankruptcy Code defines "claim" broadly to include any "right to payment," whether or not reduced to judgment, liquidated, unliquidated, disputed, equitable, unsecured, etc.

[32] The junior lienholder had filed an objection to the settlement of the trustee's usury claim, but did not bother to exercise his right to appeal the bankruptcy court's approval of the settlement, instead seeking to relitigate the issue by way of an impermissible separate action.

Given those matters of which Respondent Court took judicial notice, Petitioner submits that it was not within Respondent Court's discretion to conclude other than that Real Parties are bound by the Bankruptcy Court Order, whether as assignees, or as the holders of purported independent "rights" (a status which Petitioner vigorously disputes and which was not alleged in the underlying amended complaints) and who thus are bound by reason of privity with those who received notice of and/or participated in the July 28, 1986 Bankruptcy Court hearing.[33] Indeed, Real Parties' arguments in this respect, and Respondent Court's failure properly to exercise its discretion and to apply the correct legal principles, evinces a fundamental misunderstanding of the prior Bankruptcy Court action and the propriety of what occurred in 1986.

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[33] Significantly, the law firm of Crosby, Heafy, Roach & May, one of Real Parties' counsel in the State Actions, actually was served directly with the July 1986 Notice of Hearing on behalf of Real Party Heller Financial, Inc. Given that firm's representation of Real Parties, their claim of lack of notice and/or lack of privity, quite simply, does not ring true.

Moreover, there are others with whom Real Parties were in privity for purposes of the Bankruptcy Court Order, such as the former TEC directors and officers from whom Real Parties received assignments and possibly TEC itself, who was suing certain of the former TEC directors and officers for breach of fiduciary duty.

EXCERPTS FROM APPELLANT'S OPENING BRIEF

* * *

3. The directors and officers are bound by the bankruptcy court order approving the cancellation of the D & O policy.

a. The bankruptcy court order is entitled to full faith and credit in this action.

The trial court refused to give res judicata effect to the bankruptcy court's order approving cancellation and its finding that adequate notice was given to all parties entitled thereto. It reasoned that "the directors and officers were not properly given notice and an opportunity to be heard" (A.A. p. 2174) and "the notice [of the July 28 hearing] failed to comply with the bankruptcy rules regarding either advisory [sic] proceedings or contested matters. . . . See Bankruptcy Rule 7004." (A.A. p. 2177.)

National Union believed that the trial court had erroneously refused to give full faith and credit to a final federal court order.[33] Accordingly, it applied for a preliminary injunction in the United States District Court for the

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[33] (See *Levy v. Cohen* (1977) 19 Cal.3d 165, 172 [bankruptcy court order releasing limited partners from all debts and liabilities incurred on behalf of partnership was res judicata regarding liability of partners for partnership obligations and entitled to full faith and credit in state court action against partners]; *Del. Valley Citizens' Council v. Com. of Pa.* (3rd Cir. 1985) 755 F.2d 38, 43 ["[T]here 'is clearly established rule that state courts must give full faith and credit to the proceedings of federal courts[.] That this is the rule is beyond doubt, and the state courts have generally accepted it.' " . . . " 'It would be unthinkable to suggest that state courts should be free to disre-

Northern District of California restraining the trial court from entering any judgment in the *Technical Equities* coordination proceeding predicated on the conclusion the cancellation of the D & O policy was invalid. (*National Union Fire Insurance Company of Pittsburgh, Pa. v. Aaronson, Dickerson, Cohn & Lanzone, etc., et al.* No. C-90-20561-WAI.)

On January 28, 1991, the district court, noting that National Union had already filed an appeal in this action, declined to exercise its discretion to issue the injunction. It held: "The issues have been properly and squarely presented to the California appellate courts" and "doubts as to the appropriateness of an injunction should be resolved 'in favor of permitting the state courts to proceed in an orderly fashion to finally determine the controversy'. . . . " Therefore, the issue whether the bankruptcy court's order was entitled to full faith and credit and should be given res judicata effect in this action is squarely presented by this appeal. (See *Golden v. Pacific Maritime Ass'n* (9th Cir. 1986) 786 F.2d 1425, 1427 ["[I]ssue and claim preclusion arguments may be made in state court after the federal court declines to grant an injunction"].)

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gard the judgments of federal courts. . . . ' "]; *Chicot Co. Drainage Dist. v. Baxter State Bank* (1940) 308 U.S. 371 [84 L.Ed. 329, 60 S.Ct. 317] [final bankruptcy court orders are equivalent to final federal district court orders for res judicata purposes]; *Mueller v. Elba Oil Co.* (1942) 21 Cal.2d 188, 205; *Heffron v. Rosenberg* (1942) 51 Cal.App.2d 156, 160.)

b. The notice to the directors and officers was constitutionally adequate and, therefore, the bankruptcy court order is not subject to collateral attack. The directors' and officers' only remedy was by appeal or motion in the bankruptcy court.

In determining whether the bankruptcy court order should be given res judicata effect, this court must look to federal law. (See *Merry v. Coast Community College Dist.* (1979) 97 Cal.App.3d 214, 222 ["Because the prior judgment in the instant case was rendered by a federal court, it must be given the same effect by state courts that it would have in a federal court"; Rest. 2d Judgments § 87, p. 314 ["Federal law determines the effects under the rules of res judicata of a judgment of a federal court"].)

The federal courts uniformly hold that any notice that a bankruptcy court hearing will affect a person's interests is sufficient to meet constitutional due process standards, and a person receiving such notice ignores the proceedings at his or her peril. In *Matter of Gregory* (9th Cir. 1983) 705 F.2d 1118, an unsecured creditor received notice of a creditor's meeting and a confirmation hearing. A copy of the debtors' plan was not included with the notice. The plaintiff did not attend the meeting and the debtor's plan was confirmed. The Ninth Circuit Court of Appeals held that, although the notice received by the plaintiff "was not unambiguous" (*id.*, at p. 1123), it satisfied constitutional due process standards, and the bankruptcy court order could not be challenged in a subsequent action:

> "When the holder of a large, unsecured claim such as Lawrence receives any notice from the bankruptcy court that its debtor has initiated bankruptcy proceedings, it is under constructive or inquiry notice that its claim may be affected, and it ignores the proceedings to which the notice refers at its peril. . . . If Lawrence had made any inquiry following receipt of the notice, it would have discovered that it needed to act to protect its interest." (*Ibid.*)

(See also *In re Price* (9th Cir. 1989) 871 F.2d 97, 99 ["(' . . . [M]ere knowledge of a pending bankruptcy proceeding is sufficient to bar the claim of a creditor who took no action, whether or not that creditor received official notice from the court of various pertinent dates')"]; *In re Coastal Alaska Lines, Inc.* (9th Cir. 1990) 920 F.2d 1428 [creditor aware of bankruptcy proceeding is put on inquiry notice and absence of notice of claims bar date therefore does not violate creditor's right to due process of law]; *Matter of Robintech, Inc.* (5th Cir. 1989) 863 F.2d 393, 397 [creditor who should have been generally aware of bankruptcy and of the possibility of having to prepare a claim is not deprived of due process although a bankruptcy court's order setting bar date within which proofs of claim must be filed was misaddressed, and creditor received only 13 days notice]; *Matter of Georgetown Apartments* (M.D.Fla. 1979) 468 F.Supp. 844, 851-852 ["Although the notice given by the Bankruptcy Court regarding dismissal was not ideal under all circumstances, in this case the notice and hearing were adequate to satisfy both the requirements of Bankruptcy Rule 12-41 and Section 481(2) [11 U.S.C. § 881(2)], and of constitutional due process of law"]; see also *In re Marino* (9th Cir.

1986) 794 F.2d 1367, 1370; *In re General Tire & Rubber Co. Sec. Litigation* (6th Cir. 1984) 726 F.2d 1075, 1086.)

Here, like the plaintiff in *Gregory*, the directors and officers had notice of both Technical Equities' bankruptcy and of the July 28, 1986 hearing. Each was served with notice of that hearing. (Ex. 4239.) The directors and officers were under notice that their interests might be affected and that they ignored the July 28 hearing at their peril. Just as in *Gregory*, if they had made any inquiry following receipt of notice, e.g., if they had examined the motion itself,[34] they would have discovered what, if anything, they needed to do to protect their interests. In short, the notice of the hearing clearly satisfied constitutional due process requirements.[35]

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[34] The notice of hearing on the motion to approve cancellation of the D & O policy stated: "The complete terms of the compromise are set forth in the Motion. Copies of the Motion and the exhibits thereto, include the Policy and a draft of the Successor Policy, are on file with the court." (Ex. 4239.)

[35] The bankruptcy court also complied with bankruptcy court procedures. Consistent with the bankruptcy rules and code, its notice stated the matter to be compromised, the terms of the compromise, and the time and place of the hearing. (Ex. 4239; see Bankruptcy Rules 2002 and 9019, and Bankruptcy Code § 102(1).) The trial court's conclusion that the compromise could be effected only by way of an adversary proceeding or contested matter was in error. Rule 7001 specifies the types of matters which can or may be heard in an adversary proceeding. Approval of a compromise is not one of them. Rule 9014, governing "contested matters," expressly applies only in cases "not otherwise governed by these rules." Rule 2002(a) expressly provides that the proper procedure for the approval of a compromise is a noticed motion, the procedure which was followed in the Technical Equities bankruptcy. Thus, the directors and offi-

The trial court's conclusion that the notice of the hearing was constitutionally defective was based on inapposite authorities. It relied on *New York v. New York, N. H. & H. R. Co.* (1953) 344 U.S. 293 [97 L.Ed. 333, 73 S.Ct. 299] and *Mullane v. Central Hanover B. & T. Co.* (1950) 339 U.S. 306 [94 L.Ed. 865, 70 S.Ct. 652]. (A.A. pp. 2174, 2178.) In each case, however, the party complaining received no actual notice at all, but was served only by publication. Thus, neither case supports the trial court's conclusion that the receipt of actual but allegedly incomplete notice constitutes a violation of due process.

If the directors and officers believed they received inadequate notice, their only remedy was by appeal or other direct attack in bankruptcy court (e.g., a motion to set the order aside pursuant to Fed. Rules Civ. Proc., rule 60(b), as incorporated by rule 9024 of the bankruptcy rules), not a collateral attack in state court. (*Heffron v. Rosenberg, supra,* 51 Cal.App.2d at p. 160; see also *Mueller v. Elba Oil Co., supra,* 21 Cal.2d at pp. 205, 207 ["[W]here the judgment or decree of the Federal Court determines a right under a Federal statute, that decision " 'is final until reversed in an appellate court or modified or set aside in the court of its rendition.' " "Perhaps upon appeal, or other form of review in the federal courts, it might have been held that the referee's order of compromise and release was erroneous . . . but the state court is not a court of review for proceedings in the federal bankruptcy court"]; *Martin v. Martin* (1970) 2 Cal.3d 752, 762 [order of

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cers received timely and proper notice under bankruptcy court procedures. Once again, the trial court's contrary conclusion was without legal support.

bankruptcy court may be challenged only by way of direct appeal in federal court]; *Miller v. R. K. A. Management Corp.* (1979) 99 Cal.App.3d 460, 468 ["Under federal law, a judgment or order, once rendered, is final for purposes of res judicata until reversed or modified on appeal or set aside in the court of rendition. [Citations.] This is the rule even though the bankruptcy court's order is in excess of its jurisdiction or unconstitutional"]; Rest. 2d Judgments, § 78, com. a ["Relief through the medium of attacking a judgment when it is relied upon in a subsequent action often is in form and generally is in substance an equitable defense or counterclaim against the person relying on the judgment. Hence, the principle that equity will not grant relief when there is an adequate legal remedy implies that relief must ordinarily be sought through a 60(b) type of motion in preference to these other procedures"].)

c. Considerations of jurisdiction and comity among courts preclude a collateral attack on a final bankruptcy court order in a subsequent state court action.

Considerations of jurisdiction and comity counsel against a collateral attack in state court on a final federal court order. (See *Clark's Fork Reclamation Dist. v. Johns* (1968) 259 Cal.App.2d 366, 369 [the prior filing of a like federal court action raises "questions of comity calling for exercise of a circumspect discretion by the state court in which the latter action is commenced"]; *Lapin v. Shulton, Inc.* (9th Cir. 1964) 333 F.2d 169, 172 ["[C]onsiderations of comity and orderly administration of justice demand that the nonrendering court should decline jurisdiction of

such an action and remand the parties for their relief to the rendering court, so long as it is apparent that a remedy is available there"]; *Del. Valley Citizens' Council v. Com. of Pa., supra,* 755 F.2d at p. 44 ["[W]here the judgment or decree of the federal court determines a right under a federal statute, that decision is 'final until reversed in an appellate court, or modified or set aside *in the court of its rendition.*'. . . . 'Any other conclusion strikes down the very foundation of the doctrine of *res judicata,* and permits the state court to deprive a party of the benefit of its most important principle, and is a virtual abandonment of the final power of the Federal courts to protect all who come before them relying upon rights . . . established by the judgments of the Federal courts' "]; Rest. 2d Judgments, § 78, p. 229, com. a ["In broader context, preference for the motion procedure is an expression of the principle of comity among courts. The principle is that a court should not assume to disturb another court's disposition of a controversy unless there are good reasons for doing so. The principle is a guideline rather than a rule of jurisdiction, *though in application between courts of different judicial systems it may have jurisdictional significance*"] emphasis added.)

Jurisdiction and comity among courts are particularly compelling considerations under the facts of this case. First, both a debtor and a debtor's insurance policy are within the exclusive jurisdiction of the bankruptcy court (*MacArthur Co. v. Johns-Manville Corp.* (2nd Cir. 1988) 837 F.2d 89, 91; *In re Minoco Group of Companies, Ltd., supra,* 799 F.2d at p. 519). Therefore, only that court can make a conclusive determination of the debtor's rights under the policy. Any attempt by a state court to adjudicate such

matters would be inconsistent with the exclusive jurisdiction of the federal courts. (*Gonzales v. Parks* (9th Cir. 1987) 830 F.2d 1033, 1035; *Miller v. R. K. A. Management Corp., supra,* 99 Cal.App.3d at p. 466.)[36]

Second, if bankruptcy court orders can be reviewed and rejected by state courts, conflicting decisions by the state and federal courts are inevitable. Indeed, that conflict has already occurred, to the severe detriment of National Union. After ruling in this case that the bankruptcy court's order was not binding on the directors and officers, the trial court instructed the jury in *McLaughlin, et al. v. National Union* that the cancellation of the D & O policy was "invalid" and, as a result, the policy limits were $30,000,000, *"a bankruptcy order to the contrary notwithstanding."* (Emphasis added.) Based on those instructions, the jury in *McLaughlin* found that National Union had acted in bad faith in rejecting a purported $24,000,000 offer to settle within the $30,000,000 policy limits. Applying that finding, the trial court entered judgment against

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[36] Nonetheless, the trial court held that because the cancellation of the D & O policy was invalid, Technical Equities as debtor in possession was not entitled to a refund of the unearned premium on the D & O policy and therefore owed National Union $1634 in premiums if its new directors and officers wished to be covered by the successor policy. (A.A. pp. 2178-2188.) In other words, the trial court purported to adjudicate the rights and obligations of an entity subject to the exclusive jurisdiction of the bankruptcy court and placed its own conditions on a compromise (i.e., the issuance of the successor policy) approved by the bankruptcy court. By affecting the rights of the new directors and officers in the successor policy, even though they are not parties to this action, the trial court did precisely what it accused the bankruptcy court of doing.

National Union for $48,943,165.45, including $43,000,000 in punitive damages assessed by the jury, and subsequently held that National Union was estopped by that finding from contesting liability in *Abelson v. National Union*, which resulted in a $120,500,181 judgment. However, if the bankruptcy court ruling had been given full faith and credit, the policy limits were, at most, $20,000,000, and the $24,000,000 settlement offer was *beyond* policy limits. National Union could not have acted in bad faith in relying upon a final federal court order. Nevertheless, the trial court caused National Union to be punished to the tune of almost $170,000,000 for relying on that order.

d. Plaintiffs are bound by the bankruptcy court's order approving the cancellation of the D & O policy.

Plaintiffs are also bound by the bankruptcy court order. First, to the extent plaintiffs assert claims against National Union as assignees of the directors and officers,[37] they are bound by the bankruptcy court's order approving the cancellation of the D & O policy to the same extent as the directors and officers. (*Woolett v. American Employers Ins. Co.* (1978) 77 Cal.App.3d 619, 625-626 [injured person's claim based on assignment from

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[37] In *McLaughlin v. National Union, supra*, the plaintiffs, in addition to asserting direct causes of action against National Union under Insurance Code section 790.03, also sought damages as assignees of the directors and officers based on National Union's alleged failure to accept a purported offer to settle within policy limits.

insured barred by prior judgment establishing the insurer had no obligation to indemnify the insured for his liability to the injured person]; *Doser v. Middlesex Mutual Ins. Co.* (1980) 101 Cal.App.3d 883, 890 [assignor-insured must possess valid cause of action before its assignee can prevail against the insurer].) Thus, just as the directors and officers are bound by the bankruptcy court order (see discussion, *supra*), so are plaintiffs as assignees of the directors and officers.

Second, to the extent plaintiffs' claims are based on Insurance Code section 790.03, they were parties to the bankruptcy proceedings and are bound by the order approving cancellation of the D & O policy. Plaintiffs were clearly unsecured creditors of Technical Equities[38], and creditors are deemed parties to and bound by a bankruptcy proceeding. (*Levy v. Cohen, supra,* 19 Cal.3d at p. 172; *MacArthur Co. v. Johns-Manville Corp., supra,* 837 F.2d at pp. 91-93; 9 *Collier on Bankruptcy* (15th ed. 1988) ¶ 9019.03, p. 9019-5.)

Third, plaintiffs are bound because they were in privity with persons who were parties to those proceedings. Privity exists where: (1) the non-party had an identity of interest with, and adequate representation by, the party

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[38] Section 101(10)(A) of the Bankruptcy Code defines "creditor" as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." Section 101(5)(A) of the Bankruptcy Code defines "claim" broadly to include any "right to payment," whether reduced a judgment, liquidated, unliquidated, disputed, equitable, unsecured, etc.

in the first action; and (2) the non-party should reasonably have expected to be bound by the prior adjudication. (*Frazier v. City of Richmond* (1986) 184 Cal.App.3d 1491 [judgment in prior class action res judicata as to non-parties].) A person not a party to a prior adjudication may be bound thereby if a party to the action can be fairly treated as acting in a representative capacity for the non-party. (*Armstrong v. Armstrong* (1976) 15 Cal.3d 942, 951 ["[P]rivity exists where the person involved is ' " . . . so identified in interest with another that he represents the same legal right" ' "].) As the United States Court of Appeals for the Ninth Circuit explained in *United States v. Geophysical Corp.* (9th Cir. 1984) 732 F.2d 693, 697, "A person technically not a party to the prior action may be bound by the prior decision if his interests are so similar to a party's that that party was his 'virtual representative' in the prior action. . . . A finding of virtual representation may be based on an express or implied legal relationship that makes a party to the prior action accountable to a non-party."

Here, plaintiffs were in privity with at least four separate parties or groups who received notice of the July 28, 1986 hearing at which the bankruptcy court approved the cancellation of the D & O policy:

(a) *The trustee in bankruptcy.* The trustee was clearly "so identified in interest" with plaintiffs that he represented "the same legal right" (*Armstrong v. Armstrong, supra,* 15 Cal.3d at p. 951) and was their "virtual representative." (*United States v. Geophysical Corp., supra,* 732 F.2d at p. 697; see *In re Dominelli* (9th Cir. 1987) 820 F.2d 313, 317 ["The trustee, as representative of the estate, normally can represent each general creditor as effectively as

could the creditor itself"].)[39] Plaintiffs were creditors of Technical Equities (see fn. 38, *supra*); their interests were fully represented by the trustee.

(b) *Counsel for an uncertified class of plaintiffs.* Counsel for a class of plaintiffs which had filed a class action against the directors and officers received actual notice of and appeared at the July 28, 1986 hearing. (Ex. 4111.) That counsel, as representative of a purported class which presumptively included all persons with claims against the directors and officers, owed fiduciary duties to plaintiffs and was therefore their "virtual representative" (*United States v. Geophysical Corp., supra,* 732 F.2d at p. 697) in that action. (See *City of San Jose v. Superior Court* (1974) 12 Cal.3d 447, 464 ["This court has long been concerned with requiring the representative party to protect the interests of the absent class members. . . . To fulfill this fiduciary duty the representative plaintiff must raise those claims 'reasonably expected to be raised by the members of the class' "]; *Gill v. Monroe County Dept. of Social Services* (W.D.N.Y.1981) 92 F.R.D. 14, 17; 1 Moore's Federal Practice Manual for Complex Litigation (2d ed. 1985) § 30, pp. 195-196 ["The attorneys and parties seeking to represent the class assume fiduciary responsibilities to the class"].)

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[39] The Ninth Circuit in *In re Dominelli* recognized that "the trustee has interests that on occasion conflict with those of an individual secured creditor. [Citations.] In cases of conflict, all interests should be represented in the bankruptcy court." (*Ibid.*) However, plaintiffs never offered any evidence that the trustee had interests in conflict with their interests as unsecured creditors.

(c) *Counsel for the unsecured creditors committee.* The unsecured creditors committee in the Technical Equities bankruptcy proceeding received notice of and was represented by counsel at the July 28 hearing. (Exs. 4111, 4239.) The committee's counsel did not object to the agreement to cancel the D & O policy. Moreover, he expressly approved the form and content of the order. (Ex. 4031.) As unsecured creditors, plaintiffs were in privity with the unsecured creditors committee and are bound by the order approving the cancellation of the D & O policy. Like counsel for the federal class action plaintiffs, any member of the unsecured creditors committee "undertakes to act in a fiduciary capacity on behalf of the members of the class he represents." (*In re Johns-Manville Corp.* (S.D.N.Y. 1983) 26 B.R. 919, 924.)[40]

(d) *Heller Financial, Inc.* Heller Financial, Inc., a Technical Equities investor, received actual notice of the July 28, 1986 hearing through service on its attorneys, the firm of Crosby, Heafey, Roach & May. (Ex. 4239.) (Crosby,

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[40] The trial court reasoned that plaintiffs were not adequately represented by either counsel for the class action plaintiffs or by counsel for the unsecured creditors' committee because neither said anything prior to the bankruptcy court's order approving cancellation of the D & O policy. (A.A. pp. 2181-2182.) The court's reasoning misses the point. Both counsel, who represented parties in privity with plaintiffs, received notice of the hearing, appeared, and had the *opportunity* to object to cancellation if they felt it was not in their clients' best interests. They could not shield their clients and their clients' privies from the collateral estoppel effect of a ruling by failing to object. (*Chicot Co. Drainage Dist. v. Baxter State Bank, supra,* 308 U.S. at p. 378 [84 L.Ed. at pp. 334-335, 60 S.Ct. 317]; *Levy v. Cohen, supra,* 19 Cal.3d at pp. 173-174.)

Heafey was also one of the counsel that filed the third amended complaint in this case (A.A. p. 873.).) Heller represented interests in the bankruptcy action identical to those of the plaintiffs in this action (and all other investors who sued Technical Equities' directors and officers), namely, protecting any interests they perceived they had in the third year of the D & O policy. Because Heller "represent[ed] the same legal right" as plaintiffs with respect to the D & O policy, plaintiffs were necessarily in privity with Heller and bound by the bankruptcy court order. (See *Armstrong v. Armstrong, supra,* 15 Cal.3d at p. 951, internal quotation marks omitted.)

The trial court relied on *Shapiro v. Republic Indem. Co. of America* (1959) 52 Cal.2d 437 and *New Amsterdam Casualty Company v. Murray* (6th Cir. 1957) 242 F.2d 549, for the proposition plaintiffs are not bound by the bankruptcy court order. Each held an injured person's rights against the tortfeasor's insurer arise upon the happening of an accident and cannot thereafter be abridged by a judgment reforming or canceling the policy if the injured person is not a party to the judgment. These cases are inapplicable for three reasons.

First, as assignees of the directors and officers, plaintiffs are bound by the bankruptcy court order to the same extent as the directors and officers. (*Woolett v. American Employers Ins. Co., supra,* 77 Cal.App.3d at pp. 625-626.) Second, in neither *Shapiro* nor *New Amsterdam* was the injured person a party to the proceedings where the policy was canceled. Here, plaintiffs were parties to and in privity with other parties to the bankruptcy court proceedings. Third, *Shapiro* and *new Amsterdam* involved automobile liability policies, which are written on an

occurrence basis. Under an occurrence policy, coverage is triggered when an insured event happens, not when the insured or insurer is notified of the event. (*VTN Consolidated, Inc. v. Northbrook Ins. Co.* (1979) 92 Cal.App.3d 888, 891.) In contrast, under a claims made policy, coverage is triggered only when a claim is made and notice is given to the insurer. If a claim is not made until after expiration of the policy, there is no coverage even if the wrongful act occurred while the policy was in effect.

It follows that, when the bankruptcy court approved the cancellation of the D & O policy, the third year of the policy had not begun, and plaintiffs could have no rights or interest in the policy's third year $10,000,000 policy limit. Any rights which plaintiffs might have had on the date of cancellation could be based only on claims *already reported* to National Union. Such claims, however, would have triggered coverage under the *second*, not the *third* policy year.[41]

Because plaintiffs had no vested rights in the D & O policy's third year coverage limit when it was canceled, they are bound by the bankruptcy court's order.

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[41] The same result follows even assuming (incorrectly) that a loss occurred and coverage was triggered under the D & O policy when a claim was made to the directors and officers, not when it was reported to National Union.

EXCERPTS FROM

APPELLANT'S REPLY BRIEF

* * *

A. The Bankruptcy Court Approved An Agreement Between Technical Equities And National Union To Cancel The D & O Policy.

Following Technical Equities' February 7, 1986 bankruptcy, the corporation's newly constituted board of directors faced a dilemma. The conduct of the prior board had prompted hundreds of claims which threatened to exhaust the policy limits of Technical Equities' D & O policy, leaving no insurance coverage for the new board. Because the corporation had been driven into bankruptcy, no funds were available to purchase a new D & O policy. Seeking a solution to this dilemma, the board authorized its new chairman, Jonathan Wilcox, to negotiate with National Union to obtain $5,000,000 in directors and officers liability coverage for a twelve month period "if no additional premiums need be paid." (Ex. 4279, p. 3.)

Mr. Wilcox was successful. Following negotiations, National Union agreed to cancel the existing D & O policy effective July 13, 1986 subject to the issuance of a new $5,000,000 policy commencing July 13 and covering claims based on post-bankruptcy acts. (Ex. 4021.) In addition, Technical Equities elected extended discovery under Clause 8(a) of the cancelled D & O policy, i.e., any post-cancellation claims based on pre-bankruptcy acts would be deemed made prior to the July 13 cancellation. (Ex. 4222.) The agreement satisfied the new board's desire that no additional premiums be paid for continued directors and officers liability coverage. The premiums for the new

policy and for extended discovery were equal to the unearned premium on the cancelled policy, so nothing was owed by either Technical Equities or National Union. (Ex. 4097 [George Yuhas Deposition at p. 70]; Ex. 4239 [Notice of Hearing for an Order Approving Compromise, p. 2].) At a July 28, 1986 hearing held pursuant to a noticed motion, the bankruptcy court approved the agreement between National Union and Technical Equities "as being in the best interest of the estate and creditors." (Ex. 4031.)

The trial court in this case undid the arrangement approved by the bankruptcy court. It held the cancellation was invalid because the notice of the July 28 bankruptcy court hearing was legally inadequate and the $10,000,000 policy limits under the third year were therefore available to pay claims arising out of Technical Equities' financial demise. (A.A. pp. 2168-2182.) In addition, the trial court held that, because the cancellation was invalid, Technical Equities was not entitled to return of the unearned premium, even though that was the consideration for the successor policy. Ignoring the bankruptcy court's order approving issuance of the successor policy to Technical Equities as debtor in possession without the payment of an additional premium, the trial court held the debtor owed National Union a premium of $1634 for that policy. (A.A. pp. 2187-2188.) The court's ruling stripped the new directors of coverage under the successor policy, the issuance of which had been authorized by the bankruptcy court.

These rulings were clear error. They failed to give full faith and credit to a final federal court order (*Levy v.*

Cohen (1977) 19 Cal.3d 165, 172) and ignored the bankruptcy court's exclusive jurisdiction over the debtor's property, including its insurance policies (*MacArthur Co. v. Johns-Manville Corp.* (2nd Cir. 1988) 837 F.2d 89, 91, 92). Plaintiffs' arguments in support of the trial court's rulings cannot withstand analysis. In many instances those arguments are predicated on shocking misstatements of the record and the holdings of the applicable authorities.

B. The Bankruptcy Court Order Is Res Judicata As To Every Issue That Was Litigated Or Might Have Been Litigated.

According to plaintiffs, "[i]t is hornbook law, under both state and federal law, that '[t]he doctrine of *res judicata* extends only to issues that have been litigated. . . . '" (R.B. p. 39.) Therefore, argue plaintiffs, because the bankruptcy court approved a compromise agreement between Technical Equities and National Union, rather than resolving a litigated matter, its ruling that the D & O policy was cancelled effective July 13, 1986, is not entitled to full faith and credit and should not be given res judicata effect in this action.

Wrong. Both the United States and the California Supreme Courts hold that final bankruptcy court orders are binding in subsequent actions as to all matters which were or *might have been* litigated.[28] (*Chicot Co. Drainage*

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[28] Plaintiffs do not deny that federal law determines the res judicata effect of the bankruptcy court's order. (See *Merry v. Coast Community College Dist.* (1979) 97 Cal.App.3d 214, 222; Rest. 2d Judgments, § 87, p. 314; A.O.B. p. 45.) Where we cite

Dist. v. Baxter State Bank (1940) 308 U.S. 371, 375, 378 [84 L.Ed. 329, 333, 334-335, 60 S.Ct. 317] [Bankruptcy court order cancelling bonds was res judicata even though the statute under which it acted was subsequently held unconstitutional and the constitutionality of the statute had not been challenged in the bankruptcy proceeding. "[T]hese bond holders, having the opportunity to raise the question of invalidity, were not the less bound by the decree because they failed to raise it. . . . [¶] [R]es judicata may be pleaded as a bar, not only as respects matters actually presented to sustain or defeat the right asserted in the earlier proceeding, 'but also as respects any other available matter which might have been presented to that end' "]; *Levy v. Cohen, supra,* 19 Cal.3d at pp. 173-174 [Bankruptcy court order cancelling individuals' debts incurred on behalf of partnership binding in subsequent state court action even though, under former 11 U.S.C. § 23(j), the bankruptcy court was without jurisdiction to discharge the liability of an individual for the obligations of a partnership. "[I]f plaintiff had an opportunity to litigate such question in that proceeding, his failure to do so would not eliminate, in the present action, the conclusive effect of the bankruptcy court's determination that defendants are not liable for debts of the limited partnership. . . . [¶] Since the objection could have been raised in the bankruptcy proceeding, the order confirming plan of arrangement is conclusive in the present action insofar as such order determined that defendants

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California cases, we do so because we believe they are indicative of federal law.

are not liable for the obligations of the limited partnership"].)

The same analysis applies here. The bankruptcy court's ruling that the D & O policy was cancelled effective July 13, 1986, must be given res judicata effect irrespective of whether the cancellation was actually contested. Every director and officer was a party to the bankruptcy proceeding and was given notice of the July 28 hearing. (Ex. 4239.)[29] Each had an opportunity to object before the compromise was approved. Their failure to do so does not eliminate the conclusive effect of the bankruptcy court's order.

Plaintiffs' contention that the bankruptcy court made no rulings concerning the policy limits of the D & O policy misses the point. Assuming that the state courts may decide the D & O policy's limits, they still cannot make any rulings regarding those limits which ignore the conclusive effect of the bankruptcy court's final ruling that the policy was cancelled effective July 13, 1986. Yet, that is precisely what the trial court did here. It ruled that the bankruptcy court order was invalid and not entitled to full faith and credit, and, therefore, the policy was still in effect when claims were made against the directors and officers in the third policy year, and the third year's $10,000,000 limits were therefore available to pay those

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[29] Plaintiffs contend director Paul Knauff did not receive notice of the hearing. (R.B. p. 50.) However, a copy of that notice was served on the law firm of Heller, Ehrman, White & McAuliffe. (Ex. 4239.) The Heller firm represented the outside directors of Technical Equities, including Paul Knauff. (A.A. p. 12; Ex. 4251.)

claims. (A.A. pp. 2174, 2177.) As the trial court's instructions to the jury in the subsequent *McLaughlin v. National Union* bad faith action demonstrate, it realized full well its ruling was in direct conflict with the bankruptcy court's order: "Cancellation of the third year of the D & O policy was invalid, and had no effect on the plaintiffs herein, *a bankruptcy order to the contrary notwithstanding.*" (Instruction 31, emphasis added.)

The authorities relied on by plaintiffs for the proposition that res judicata extends only to issues that were litigated are clearly distinguishable. In each case, the court held the action was not barred by a judgment in a prior case because different issues were involved in the two proceedings. *Smith v. Lujan* (9th Cir. 1979) 588 F.2d 1304, one of the cases relied on by plaintiffs, is illustrative. In *Smith,* the United States Court of Appeals for the Ninth Circuit held that an action by a decedent's heirs for re-execution of a 1960 lease was not barred by a prior judgment which determined that a 1968 lease executed by the estate's administrator was void for lack of proper notice to the heirs. The court explained that the only issue in the prior action was whether the 1968 lease was void, not whether the decedent had executed a lease in 1960.

In contrast, the bankruptcy court and the trial court in this case decided the identical issue – whether the D & O policy was cancelled effective July 13, 1986. Because the bankruptcy court's order cancelling the policy is final, it is entitled to full faith and credit and must be given res judicata effect. The trial court could make no ruling which conflicted with that final order.

C. Plaintiffs' Contention That Every Court Has Rejected National Union's Res Judicata Argument Misrepresents The Record.

Plaintiffs contend that "every court which has examined this issue" has rejected National Union's argument that the bankruptcy court's order is res judicata. (R.B. p. 39.) False. Only the trial court in this case has addressed the merits of National Union's res judicata argument.

First, the bankruptcy court has never held that its own order approving cancellation of the policy is not res judicata. The bankruptcy court may not have decided the *effect* of its order on coverage matters, but it has never held the state courts could make rulings premised on the invalidity of that order.

Second, neither the United States District Court nor the United States Court of Appeals for the Ninth Circuit has rejected National Union's res judicata contention. In denying National Union's motion for a preliminary injunction in *National Union Fire Ins. v. Aaronson, Dickerson, Cohn & Lanzone,* the United States District Court merely held that because the same issues raised by National Union's motion "ha[d] been properly and squarely presented to the California Appellate courts, . . . doubts as the appropriateness of an injunction should be resolved 'in favor of permitting the state courts to proceed in an orderly fashion to finally determine the controversy'. . . . " (R.A. pp. 601-602.) Thus, the United States District Court held that the claim should be decided by this court on this appeal. Similarly, the United States Court of Appeals merely held that the district court had not abused its discretion in deferring resolution of

the res judicata issue to the state appellate courts. (R.A. p. 973.)

Plaintiffs have misrepresented what the United States District Court held in yet another respect. According to plaintiffs, the court "also ruled that sanctions against National Union were appropriate." (R.B. p. 42.) In fact, the United State [sic] District Court made only the following ruling: "The request of the Kouns defendants for a hearing of their request for sanctions against plaintiff for *purported* violations of Rule 11 F.R. Civ. P., is granted, but hearing is deferred until after trial on the issue of a permanent injunction, if there is such a trial." (R.A. p. 592, emphasis added.)

Third, contrary to plaintiffs' assertion, neither this court nor the California Supreme Court has rejected National Union's res judicata claim. On June 21, 1989, this court merely denied National Union's petition for a writ of mandate on that issue without comment (R.A. p. 240) and on August 9, 1989, the California Supreme Court denied National Union's petition for review following that summary denial. (R.A. p. 241.) The summary denial of a writ petition without comment is not a ruling on the merits and does not preclude reargument of the same issues in a subsequent appeal. (*Rosato v. Superior Court* (1975) 51 Cal.App.3d 190, 230; *People v. Medina* (1972) 6 Cal.3d 484, 489-490; *Resource Defense Fund v. Local Agency Formation Com.* (1983) 138 Cal.App.3d 987, 989, fn. 3.) Similarly, the California Supreme Court's denial of a petition for review does not constitute an expression of opinion on the correctness of the Court of Appeal's action. (*People v. Triggs* (1973) 8 Cal.3d 884, 890-891.)

Accordingly, plaintiffs' contention that every court has rejected National Union's res judicata argument is totally without merit.

D. The Order Cancelling The D & O Policy Is Binding On The Directors And Officers.

Plaintiffs offer a variety of reasons why the directors and officers are not bound by the order approving cancellation of the policy even though they were served with notice of the hearing. None has any merit.

1. The Bankruptcy Court Had Jurisdiction To Cancel The D & O Policy. Moreover, Any Objections Based On Subject Matter Jurisdiction Should Have Been Raised In Federal Court, Not State Court.

Plaintiffs contend that the proceeds of the directors and officers liability coverage portion of the D & O policy belong to the individual directors and officers, not Technical Equities, and the bankruptcy court therefore had no jurisdiction to make an order affecting that coverage. (R.B. p. 49.) Not so. The D & O policy itself was the property of the estate (*In re Minoco Group of Companies, Ltd.* (9th Cir. 1986) 799 F.2d 517, 519; *In re Louisiana World Exposition, Inc.* (5th Cir. 1987) 832 F.2d 1391, 1401) and the bankruptcy court clearly had the jurisdiction to issue

orders regarding the estate's property, including insurance policies (*MacArthur Co. v. Johns-Manville Corp., supra,* 837 F.2d at pp. 91, 92).[30]

Moreover, any objections based on subject matter jurisdiction should have been made in bankruptcy court. In *Levy v. Cohen, supra,* 19 Cal.3d 165, the plaintiff in a state court action argued a prior bankruptcy court order should not be given res judicata effect because the bankruptcy court acted in excess of its jurisdiction under the Bankruptcy Code by discharging the liability of a non-debtor general partner. The California Supreme Court held plaintiff's jurisdictional objection should have been raised in bankruptcy court. "In the federal jurisdiction, the doctrine of res judicata prevents the readjudication of all matters (*including jurisdiction*) which were, or might have been, litigated in a prior proceeding between the same parties." (*Id.,* at p. 173, emphasis added.) The California Supreme Court concluded the bankruptcy court's order must be given res judicata effect because plaintiff had the opportunity "to raise his objection that the bankruptcy court lacked jurisdiction" in the bankruptcy court. (*Id.,* at p. 174.)

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[30] No purpose would have been served by cancelling only the company reimbursement portion of the D & O policy, even assuming it were possible to cancel only one portion of a single policy. Because the corporation was in bankruptcy, as a practical matter it would not be indemnifying any of its directors or officers. If that was the only portion of the policy being cancelled, there would have been no quid pro quo for National Union's agreement to issue a new policy insuring the new board of directors.

2. The Notice Of The July 28 Hearing Satisfied Due Process Requirements And The Notice Requirements Under The Bankruptcy Rules. Any Objections To The Notice Should Have Been Raised By Motion Or Appeal In Federal Court.

Plaintiffs contend the notice of the July 28 hearing did not comport with due process requirements because it failed to adequately apprise the directors and officers of the terms of the compromise and did not comply with Bankruptcy Rule 9014, which concerns notice requirements for contested matters. However, under federal law, any notice that a bankruptcy hearing will affect a person's interest is sufficient to meet constitutional due process standards, and a person receiving such notice ignores the proceedings at his or her peril. (*Matter of Gregory* (9th Cir. 1983) 705 F.2d 1118, 1123; *In re Coastal Alaska Lines, Inc.* (9th Cir. 1990) 920 F.2d 1428, 1431; *In re Price* (9th Cir. 1989) 871 F.2d 97, 99; *In re Lee Way Holding Co.* (S.D.Ohio 1990) 120 B.R. 881, 889-890 ["A notice under Bankruptcy Rule 2002 is not intended or required to fully explain the circumstances of the case, the objections to a settlement, the circumstances surrounding settlement, or other details. PepsiCo should remember that this is a Notice, not a case history. . . . Furthermore, the Notice specifically stated that copies of the Trustee's Motion and the proposed settlement agreement could be obtained from the Trustee's counsel"]; *Maher v. Zapata Corp.* (5th Cir. 1983) 714 F.2d 436, 452 [To comport with due process, a notice "need not explain . . . all the consequences involved in the settlement. It is not required to provide a complete source of settlement information. . . . " A notice

is sufficient if it "implicitly invite[s] . . . a further investigation . . . on the basis for, the background of, and the legal implications of the settlement"].)

In contrast to *New York v. New York, N.H. & H.R. Co.* (1953) 344 U.S. 293 [97 L.Ed. 333, 73 S.Ct. 299] and *Mullane v. Central Hanover B. & T. Co.* (1950) 339 U.S. 306 [94 L.Ed. 865, 70 S.Ct. 652], relied on by plaintiffs, where the parties complaining of inadequate notice received no actual notice at all but were served only by publication, the directors and officers here received constitutionally adequate notice. The notice of the July 28 hearing apprised them that: (1) the D & O policy would be cancelled effective July 13, 1986; (2) National Union would refund all unearned premiums; (3) National Union would issue a successor D & O policy and provide extended discovery under the cancelled policy at a cost which equalled the unearned premium due to Technical Equities; (4) the successor policy would cover acts of the directors and officers occurring on and after February 7, 1986, provided that claims under the successor policy were made between July 13, 1986 and July 13, 1987; (5) the limit of liability under the successor policy would be $5,000,000; (6) the motion, which set forth the complete terms of the compromise, was on file with the court, and included a copy of the D & O policy and a draft of the successor policy. (Ex. 4239.)

Plaintiffs' contention that the notice did not apprise the directors and officers that the effect of cancellation was to eliminate coverage for the third policy year's $10,000,000 limits (R.B. p. 50) is without merit. The policy, which was attached to the motion, expressly states that the policy limits are $10,000,000 per year for each of three

separate policy years. Because the motion made clear that the policy would be cancelled effective July 13, 1986, before the inception of the third policy year, *a fortiorari* it made clear that the third year's $10,000,000 liability limits would not be available to pay claims against the directors and officers. Contrary to plaintiffs' assertion, the statement in the notice of motion that National Union would "provide one year extended discovery pursuant to the terms of the Policy" (ex. 4239) could not have misled the directors and officers into thinking the liability limits of the third policy year would be available to pay claims. Clause 5(b) of the policy provided: "The limit of liability of the insurer in the discovery period shall be part of, and not in addition to, the limit of liability of the insurer in the policy year which terminates at the inception of the discovery period." The notice of motion informed the directors and officers that the policy would be cancelled effective July 13, 1986, within the second policy year. It follows that any subsequent claims would be subject to the second policy year's liability limits. Indeed, there would have been no reason to provide extended discovery under Clause 8(a) unless the policy was being cancelled prior to the inception of the third policy year. (See Knepper & Bailey, *supra*, § 21.10, at p. 710 ["D & O policies usually contain a discovery clause which permits the insureds, in case the insurer cancels or refuses to renew the policy, upon payment of an additional premium, to obtain an extension of the coverage of the policy for a specified term, but only in respect of Wrongful Acts committed before the effective date of cancellation or refusal to renew, and otherwise covered by the policy"].)

Plaintiffs' contention that the bankruptcy court's notice did not comply with the bankruptcy rules is equally without merit. Bankruptcy Rule 9019(a) provides that the court may approve a compromise or settlement by giving notice as provided in rule 2002(a). Rule 2002(a) requires 20 days notice of the hearing on approval of a compromise or settlement of controversy. The procedures delineated in rule 9014, which plaintiffs contend should have been followed here, apply only to contested matters, not the approval of compromises.[31]

Further, any error, either in the content or the timing of the notice of the July 28 hearing, should have been challenged by appeal or other direct attack in federal court, not by a collateral attack in this action. (See *Martin v. Martin*, (1970) 2 Cal.3d 752, 762.) Do plaintiffs seriously contend a state court is free to ignore a final bankruptcy order if it decides the bankruptcy court gave notice under the wrong bankruptcy rule? Clearly it is not. Procedural irregularities in the content or timing of notice do not render a judgment void and subject to collateral attack. (See *Union Joint Stockland v. Byerly* (1940) 310 U.S. 1, 7-8 [84 L.Ed. 1041, 1046, 60 S.Ct. 773] ["The District Court did not lose jurisdiction by erroneously construing or applying provisions of the statute under which it administered the bankrupt estate. Its order was voidable, but not void, and was not to be disregarded or attacked collaterally in the State Court"]; *Rico v. Nasser Bros. Realty Co.* (1943) 58 Cal.App.2d 878, 882 [" '[A]judgment or order is not

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[31] Rule 7001 specifies the types of matters which can or may be heard in an adversary proceeding. Approval of a compromise is not one of them.

subject to collateral impeachment unless it is absolutely void' "]; *Yale v. National Indem. Co.* (4th Cir. 1979) 602 F.2d 642, 650 ["Whereas failure to provide constitutional notice of course makes a resulting judgment void, a failure of mere procedural notice makes the resulting judgment merely irregular and voidable, not void"]; *Fehlhaber v. Fehlhaber* (5th Cir. 1982) 681 F.2d 1015, 1027 ["[P]rocedural irregularities during the course of a civil case, even serious ones, will not subject the judgment to collateral attack"]; Rest.2d Judgments, § 78 ["When actual notice of an action has been given, irregularity in the content of the notice or the manner in which it was given does not render the notice inadequate"].)[32]

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E. Plaintiffs, And All Other Technical Equities Investors, Are Bound By The Order Approving Cancellation Of The D & O Policy.

Plaintiffs contend they are not bound by the order approving cancellation of the D & O policy because they were not parties to the bankruptcy court proceeding. Their contention is without merit.

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[32] *In re Commercial Western Finance Corp.* (9th Cir. 1985) 761 F.2d 1329, relied on by plaintiffs (R.B. p. 52), demonstrates that the proper remedy when a bankruptcy court commits procedural error is an appeal, not a collateral attack in state court. Similarly, in *In re Golden Plan of California, Inc.* (9th Cir. 1986) 829 F.2d 705, one of the decisions relied on by the trial court in this case, the Ninth Circuit held that the United States Court's sua sponte consideration of an issue only "rendered the proceedings *procedurally defective,* because the investors were denied adequate notice." (*Id.*, at p. 712, emphasis added.)

First, to the extent plaintiffs and the other Technical Equities investors assert claims as assignees of the directors and officers (a major component of the $170,000,000 judgments in the *McLaughlin* and *Abelson* actions), they are bound by the bankruptcy court order to the same extent as the directors and officers regardless of whether the investors were parties to or in privity with parties to the bankruptcy court proceeding. (*Woolett v. American Employers Ins. Co.* (1978) 77 Cal.App.3d 619, 625-626; *Doser v. Middlesex Mutual Ins. Co.* (1980) 101 Cal.App.3d 883, 890.) Plaintiffs do not deny that, so far as their assigned claims are concerned, they stand in the shoes of the directors and officers. Instead, their argument on this point consists of nothing more than the erroneous assertion that the directors and officers were not bound by the bankruptcy court's order.

Second, plaintiffs and all other Technical Equities investors are bound by the bankruptcy court order because they were in privity with parties to the bankruptcy proceedings. "A person technically not a party to the prior action may be bound by the prior decision if his interests are so similar to a party's that that party was his 'virtual representative' in the prior action. [Citations omitted.] A finding of virtual representation may be based on an express or implied legal relationship that makes a party to the prior action accountable to a nonparty." (*United States v. Geophysical Corp.* (9th Cir. 1984) 732 F.2d 693, 697.) As we noted in our opening brief, the interests of plaintiffs and all other Technical Equities investors were represented by four separate persons or entities who were parties to the bankruptcy proceedings: The trustee in bankruptcy, counsel for an uncertified class

of plaintiffs, counsel for the unsecured creditors committee, and Heller Financial, Inc., a Technical Equities investor whose interests in the bankruptcy proceeding were identical to those of all other investors and which was represented by one of the law firms that is counsel for plaintiffs in this action. In addition to Heller Financial, Inc., 31 other investors who are plaintiffs in the *McLaughlin* and *Abelson* actions were served with notice of the bankruptcy court hearing. (Ex. 4239.)

Plaintiffs' contention that counsel for neither the class actions [sic] plaintiffs nor the unsecured creditors' committee "made an appearance at the bankruptcy hearing on the 'compromise' " (R.B. p. 46) is wrong. Both announced their appearances at the commencement of the July 28 hearing (Ex. 4111, p. 6), and counsel for the unsecured creditors committee even approved the form and content of the order cancelling the policy. (Ex. 4031.) It is irrelevant that neither counsel said anything when counsel for Technical Equities requested court approval of the agreement to cancel the policy. So long as they had the opportunity to object, they could not shield their clients or their clients' privies from the binding effect of the bankruptcy court's ruling by remaining silent. (*Chicot Co. Drainage Dist. v. Baxter State Bank, supra,* 308 U.S. at p. 378 [84 L.Ed. at pp. 334-335, 60 S.Ct. 317]; *Levy v. Cohen, supra,* 19 Cal.3d at pp. 173-174.)

The authorities relied on by plaintiffs are not in point. In *Clemmer v. Hartford Insurance Co.* (1978) 22 Cal.3d 865, the plaintiffs in an insurance coverage action contended that the insured's conduct was not willful notwithstanding his prior conviction of the second degree murder of plaintiffs' decedent. The Supreme Court held

that plaintiffs were not collaterally estopped by that conviction because the insured did not share their incentive to prove he was not guilty by reason of insanity – he might have concluded the sentence for second degree murder was preferable to acquittal and commitment to a state mental hospital. (*Id.*, at p. 877.) No such divergence of interest was present here. The trustee, the class action plaintiffs, and the unsecured creditors committee all had the same interest in establishing as much insurance as possible to cover claims against the directors and officers. The cancellation had the identical impact on each of them.

Similarly, in *Courtney v. Waring* (1987) 191 Cal.App.3d 1434, the Court of Appeal held that a bankruptcy trustee could not be treated as acting in a representative capacity for certain creditors of the bankrupt estate with similar claims. The court relied on the fact the bankruptcy court was highly skeptical of the trustee's assertion that the creditors' claims were a proper element of the trustee's damages. (*Id.*, at p. 1446.) Here, as we have shown, the investors' interests' were represented not only by the trustee, but also by the class action plaintiffs, the unsecured creditors committee, and the 32 investors who did receive actual notice of the hearing. The cancellation had the identical impact on each, and each had the identical incentive to object to the cancellation.[36]

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[36] In *Aronow v. La Croix* (1990) 219 Cal.App.3d 1039, the Court of Appeal held a malicious prosecution action was barred by res judicata where a prior malicious prosecution action by another plaintiff based on the same facts resulted in a judgment for the defendant. *Aronow* declined to follow *Courtney's* suggestion that financial or other considerations unique to the plain-

Third, regardless of whether the investors were parties to or in privity with parties to the bankruptcy proceeding, they had no rights or interest in the third policy year's $10,000,000 liability limits. Although plaintiffs contend that the investors had vested rights in the D & O policy which could not be cut off without their consent, they continue to rely only on decisions dealing with occurrence, not claims-made policies. (*Shapiro v. Republic Indem. Co. of America* (1959) 52 Cal.2d 437; *New Amsterdam Casualty Company v. Murray* (6th Cir. 1957) 242 F.2d 549; *General Ins. Co. of America v. Whitmore* (1965) 235 Cal.App.2d 670; *General of America Ins. Co. v. Lilly* (1968) 258 Cal.App.2d 465.) As we explained in our opening brief, under an occurrence policy coverage is triggered, and the rights of third party claimants vest, when an insured event happens. In contrast, there is no coverage under a claims-made policy unless a claim is made and reported to the insurer during the policy period. There is no coverage for a claim which is not made and reported until after expiration of the policy, even if the wrongful act and consequent injury occurred while the policy was in effect. (See *Gilliam v. American Cas. Co. of Reading Pa., supra,* 735 F.Supp. at pp. 346, 352 ["[T]he annual limits of liability apply to the policy years in which . . . notice of a

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tiffs in two successive actions can form the basis for a conclusion they had divergent interests. (*Aronow v. La Croix, supra,* 219 Cal.App.3d at pp. 1050-1051, fn. 5.) Moreover, the Court of Appeal in *Courtney* may have misconstrued federal law. So long as the trustee does not have interests which conflict with the creditors, any compromise agreed to by the trustee binds all of the estate's creditors, because the trustee acts as the virtual representative of, and is in privity with the creditors. (*In re Medomak Canning* (1st Cir. 1990) 922 F.2d 895, 901-902.)

claim was made." "[I]t is irrelevant when the wrongful acts occur[]. What matters is when a *loss* occurs, and losses by definition can only occur when a claim is made . . . " (original emphasis)]; *Industrial Indemnity v. Superior Court* (1990) 224 Cal.App.3d 828, 832 [No coverage where claim not reported until after expiration of policy].)[37] Therefore, any investors who made claims only after cancellation of the D & O policy had no vested rights in the policy.

The Helfand plaintiffs contend their rights could not be cut off by the cancellation because their lawsuit against the directors and officers was filed on May 5, 1986, before the bankruptcy court hearing and before National Union gave written notice of cancellation. Their argument misses the point. The Helfands and all other plaintiffs who made claims before the cancellation were second year claimants, and the cancellation did not affect their interests.

Moreover, the vested rights cases relied on by plaintiffs are distinguishable because none involved a bankruptcy court order approving the cancellation of a policy which was the property of the bankrupt estate. (See *In re Minoco Group of Companies, Ltd., supra,* 799 F.2d at p. 519.) It is one thing to hold that a state court cannot enter a binding judgment reforming or cancelling a policy if an injured person is not a party to the action. It is quite

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[37] The D & O policy provided: "The time when a loss shall be incurred within the meaning of this policy shall be the date on which [Technical Equities] . . . or the Insureds shall give written notice to [National Union] as hereinafter provided." (Ex. 4001, Clause 7(a).)

another thing to say that a bankruptcy court may not exercise its power to make dispositions of the estate's property because of the possibility of future claims by as yet unknown claimants. In fact, the bankruptcy court's order cancelling the policy operated in rem and was binding on all persons, not just those who were parties to the bankruptcy proceeding. (See *Matter of Met-L-Wood Corp.* (7th Cir. 1988) 861 F.2d 1012, 1017 [An order approving a bankruptcy sale "is an *in rem* proceeding. It transfers property rights, and property rights are rights good against the world, not just against parties to a judgment or persons with notice of the proceeding"].) Indeed, here the bankruptcy court did more than simply approve cancellation of the D & O policy. The unearned premium for the cancelled third policy year was the consideration the successor policy insuring the new board of directors. It eliminated the necessity for Technical Equities to pay a premium for the new policy. The trial court's order in this case purported to undo both aspects of the arrangement approved by the bankruptcy court.

If state courts have the authority asserted by the trial court in this case, a bankruptcy court's overall jurisdiction and ability to dispose of an estate's property in a timely fashion would be severely and irrevocably impaired. No one could obtain clear title to property acquired from a bankrupt estate even when approved by the bankruptcy court. As the United States Court of Appeals for the Ninth Circuit explained in *Gonzales v. Parks* (9th Cir. 1987) 830 F.2d 1033 at page 1035: "The ability collaterally to attack bankruptcy petitions in the state courts would . . . threaten the uniformity of federal

bankruptcy law, a uniformity required by the constitution." (See also *In re Medomak Canning, supra,* 922 F.2d at p. 901 ["In order efficiently to administer the estate, a trustee's court-approved settlement must have finality, and settling parties must be assured that those the trustee represents will not relitigate settled claims"].)

* * *

EXCERPTS FROM

PETITION FOR REHEARING OR MODIFICATION

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II.

THE COURT SHOULD NOT REACH ANY BAD FAITH ISSUE.

As a general rule, a court should address only those issues which are necessary to the resolution of an appeal. (*Agricultural Labor Relations Bd. v. Laflin & Laflin* (1979) 89 Cal.App.3d 651, 662, fn. 11 [court should avoid resolving matters "unnecessary to the decision"]; 9 Witkin, Cal. Procedure (3d ed. 1985) Appeal, § 255, pp. 261-262 [rule justified on grounds "that discussion of unnecessary matters would be neither law of the case nor a precedent, and that unnecessary discussion might be prejudicial to the interests of litigants in other actions"].) It is particularly important that a court avoid deciding unnecessary issues when a decision might infringe on the exclusive jurisdiction of a federal court and violate principles of federal-state comity. (*Williams Natural Gas Co. v. City of Oklahoma City* (10th Cir. 1989) 890 F.2d 255, 265, n.11 [" 'It would be unthinkable to suggest that state courts should be free to disregard the judgment of federal courts' "; requirement that federal court judgments command res judicata effect in state court is " ' "indispensable to federalsim" ' "]; *Clark's Fork Reclamation Dist. v. Johns* (1968) 259 Cal.App.2d 366, 369 [the prior filing of a like federal court action raises "questions of comity calling for exercise of a circumspect discretion by the state court in which the later action is commenced"].)

Here, in an attempt to avoid infringing on the jurisdiction of the bankruptcy court, this court stated:

> "We do not classify this lawsuit as a collateral attack on the bankruptcy order. Rather, plaintiffs are seeking a declaration that the insureds are entitled to the liability limits of the third policy year precisely because the bankruptcy order did not impact or determine rights as between the insurer and its insureds." (Slip opn., p. 33.)

However, by holding the cancellation violated the covenant of good faith and fair dealing, this court did much more than adjudicate the impact of the bankruptcy order. If, as this court held, the bankruptcy order did not cut off the directors' and officers' coverage for third year claims, there was never a cancellation as to them and hence no breach of the implied covenant. The cancellation constituted an act of bad faith toward the directors and officers only if the bankruptcy court purported to cut off their rights to third year coverage. But any holding that the bankruptcy court sanctioned a bad faith cancellation necessarily constitutes a collateral attack on the bankruptcy order.

By deleting its statements that the cancellation violated the covenant of good faith and fair dealing, and holding only that it did not cut off the preexisting rights of the directors and officers, this court would avoid violating principles of comity and infringing on matters

within the exclusive jurisdiction of the United States Bankruptcy Court.[6]

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[6] Because this court's opinion is published, there is all the more reason to avoid any holding that might be construed as an infringement on matters within the exclusive jurisdiction of the federal courts.

EXCERPTS FROM
PETITION FOR REVIEW

* * *

WHY REVIEW SHOULD BE GRANTED

The Court of Appeal's published opinion constitutes an unprecedented collateral attack on a final federal court order, ignores a bankruptcy court's plenary power over a debtor's property, and threatens the uniformity of federal bankruptcy law required by the United States Constitution. (*Gonzales v. Parks* (9th Cir. 1987) 830 F.2d 1033, 1035.) By relying on state law to find the cancellation was invalid, the Court of Appeal has effectively held that the power of a bankruptcy court to approve the cancellation of a debtor's insurance policy depends on the law of the state in which the bankruptcy court happens to sit. Moreover, the Court of Appeal's opinion apparently holds that a state court has the power to disregard a federal court judgment if it concludes the federal court failed to comply with its own procedural rules.

The decision has enormous practical significance. Once a petition seeking protection under Chapter 11 of the Bankruptcy Code is filed, "keeping the bankrupt in operation is difficult." (*Matter of Met-L-Wood Corp.* (7th Cir. 1988) 861 F.2d 1012, 1017.) The bankruptcy court must have the ability to approve *binding* agreements with third parties for services and supplies necessary to sustain the debtor's continued existence. (See *id.*, at p. 1019.) One of the first challenges faced by a corporate debtor is obtaining insurance coverage for its directors and officers. Without such coverage, the corporation is unlikely

to attract a team of directors and officers to guide the corporation through its reorganization. Here, the bankruptcy court obtained coverage for Technical Equities' newly constituted board of directors by approving an agreement that called for the cancellation of the existing D&O policy and using the unearned premium to purchase a policy covering the new board.

If state courts can disregard such agreements and find in addition that insurers which participate in them violate the implied covenant of good faith and fair dealing, the ability of bankruptcy courts to reorganize debtors under Chapter 11 and make binding orders regarding the disposition of their property will be seriously compromised. Given the risk a state court might subsequently find it violated the implied covenant, no insurer would agree to cancel a debtor's policy in return for the issuance of a new policy, even if a bankruptcy court found the agreement was essential to assure the debtor's continued existence. And, if a state court can ignore a bankruptcy order canceling a debtor's insurance policy if it concludes that insufficient consideration was given to the interests of third parties, what other final bankruptcy court orders concerning the disposition of a debtor's property are subject to further review in the state courts? As the United States Court of Appeals explained in *In re Medomak Canning* (1st Cir. 1990) 922 F.2d 895, 901: "In order efficiently to administer the estate, a trustee's court-approved settlement must have finality, and settling parties must be assured that those the trustee represents will not relitigate settled claims."

Review should be granted to resolve the serious res judicata and federal/state comity issues raised by the Court of Appeal's published opinion.

* * *

LEGAL DISCUSSION

I.

THE COURT OF APPEAL ERRONEOUSLY FAILED TO GIVE FULL FAITH AND CREDIT TO A FINAL BANKRUPTCY COURT ORDER.[5]

A. A Final Bankruptcy Court Order Cannot Be Collaterally Attacked In A Subsequent State Court Action.

In *Levy v. Cohen* (1977) 19 Cal.3d 165, this court held:

> "An arrangement confirmed by a bankruptcy court has the effect of a judgment rendered by a federal district court. [Citation.] The federal rule is that a judgment or order, once rendered, is final for purposes for res judicata until reversed on appeal or modified or set aside in the court of rendition. . . . [¶] Full faith and credit must be given to a final order or judgment of a federal court." (*Id.*, at p. 172.)

A final bankruptcy court order is res judicata as to all issues that were raised or *could have been raised* in the bankruptcy court proceeding. (*Chicot Co. Drainage Dist. v.*

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[5] By failing to give full faith and credit to the final bankruptcy court order, the trial court and the Court of Appeal violated the following provisions of the United States Constitution; Article I, section 8, clause 1; Article III, sections 1 and 2, Article IV, section 1; Article VI, clause 2.

Baxter State Bank (1940) 308 U.S. 371, 375, 378 [84 L.Ed. 329, 333, 334-335, 60 S.Ct. 317]; *Federal Deposit Insurance Corporation v. Jenson* (Dec. 1, 1992, No. 91-15479) ___F.2d ___, ___ [92 Daily Journal D.A.R. 16069, 16070]; *Levy v. Cohen, supra,* 19 Cal.3d at pp. 173-174.)

Moreover, a final bankruptcy court order is entitled to full faith and credit even if the bankruptcy court acted in excess of its jurisdiction. (*Levy v. Cohen, supra,* 19 Cal.3d at p. 173 [bankruptcy court order canceling individuals' debts incurred on behalf of partnership binding in subsequent state court action even though the bankruptcy court was without jurisdiction to discharge the liability of an individual for the obligations of a partnership]; *Miller v. R. K. A. Management Corp.* (1979) 99 Cal.App.3d 460, 468 [a bankruptcy court's order is final for purposes of res judicata even if it "is in excess of its jurisdiction or unconstitutional"].)

The Court of Appeal failed to clearly articulate its basis for refusing to give res judicata effect to the bankruptcy court's order approving the cancellation of the D&O policy issued to Technical Equities. At one point, it stated that its ruling did not sanction a collateral attack on the bankruptcy order because that order did not determine the rights of the directors and officers. (Slip opn., pp. 33, 35.) At other points in its opinion, however, the court made clear it was sanctioning a collateral attack. It held: (1) Even though the agreement between National Union and Technical Equities favored the corporation's continued existence, it was "arbitrary" and violated the implied covenant of good faith and fair dealing because it benefited National Union and Technical Equities at the expense of the directors and officers (slip opn., p. 52) and

(2) the directors and officers were not bound by the order because they received "constitutionally inadequate" notice (slip opn., pp. 41-42).

As we show, none of the bases offered by the Court of Appeal for refusing to give res judicata effect to the bankruptcy court order can withstand analysis.

B. The Bankruptcy Order Determined The Rights Of The Directors And Officers.

According to the Court of Appeal:

> "We do not classify this lawsuit as a collateral attack on the bankruptcy order. Rather, plaintiffs are seeking a declaration that the insureds are entitled to the liability limits of the third policy year precisely because the bankruptcy order did not impact or determine rights as between the insurer and its insureds." (Slip opn., p. 33.)

> "[T]he bankruptcy court order here did not purport to determine the rights of the insured directors and officers under the policy. Thus we conclude that the real issue framed by this lawsuit is not whether it is an impermissible collateral attack on a final bankruptcy court order, but whether the doctrine of res judicata bars plaintiffs' efforts to raise the issue of National Union's bad faith." (*Id.*, at p. 35.)

The Court of Appeal ignored the fact that National Union agreed to issue a new policy insuring the post-bankruptcy board of directors only because the third year of the existing policy, with its $10 million liability limits, was being canceled, i.e., the premium for the new policy equaled the unearned premium for the canceled policy.

Unless the agreement relieved National Union of its obligations to the directors and officers under the third policy year, it would have never issued the new policy: there would have been no unearned premium and therefore no consideration for that policy.[6] By approving the agreement between Technical Equities and National Union, the bankruptcy court necessarily determined the rights of the directors and officers in the proceeds of the third policy year.[7]

C. The Court Of Appeal Disregarded The Bankruptcy Court's Exclusive Jurisdiction Over A Debtor's Property And Sanctioned An Impermissible Collateral Attack On The Bankruptcy Order.

According to the Court of Appeal, although the cancellation made "sense" as to Technical Equities' creditors

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[6] The trial court recognized that cancellation of the directors' and officers' third year coverage, and consequent return of the unearned premium for that coverage, was an integral component of the agreement approved by the bankruptcy court. After holding that the policy had not been canceled, the trial court concluded there was no right to an unearned premium and hence no consideration for the new policy covering the post-bankruptcy board of directors. (A.A. pp. 2187-2188.)

[7] The D&O policy also provided coverage to the corporation in the event it indemnified the directors and officers. However, the bankruptcy court order clearly canceled both the corporate reimbursement and the directors and officers liability portions of the policy. Moreover, canceling only the corporate reimbursement portion of the policy would have been an idle act. Because the corporation was in bankruptcy, as a practical matter it would not be indemnifying its directors and officers. If that was the only portion of the policy being canceled, there would have been no quid pro quo for National Union's agreement to issue a new policy insuring the new board of directors.

"because it favored the debtor's continued existence" (slip opn., p. 43), the cancellation was nonetheless "arbitrary" and therefore invalid because it violated the rights of the former directors and officers:

> "National Union's willingness to help Technical Equities, DIP [debtor in possession], by issuing a new, one year, $5 million policy in favor of DIP directors and officers does not alleviate its obligations to the insured former directors and officers of the prebankrupt entity. How can a policy which excludes wrongful prebankruptcy acts help them at all? The answer is that the new deal solely benefited National Union and Technical Equities, DIP." (Slip opn., p. 52.)

By holding that the cancellation approved by the bankruptcy was "arbitrary" because it gave insufficient consideration to the interests of the directors and officers, the Court of Appeal clearly sanctioned an impermissible collateral attack on the bankruptcy order.[8] "Proceedings in bankruptcy are proceedings in rem" (*Levy v. Cohen, supra*, 19 Cal.3d at p. 172) and both a debtor and a debtor's insurance policies are within the bankruptcy court's exclusive in rem jurisdiction (*MacArthur Co. v. Johns-Manville Corp* (2nd Cir. 1988) 837 F.2d 89, 91; *In re Minoco Group of Companies, Ltd.* (9th Cir. 1986) 799 F.2d

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[8] Moreover, by affirming the trial court, the Court of Appeal apparently approved the trial court's conclusion that no coverage was available under the successor policy unless Technical Equities, as debtor-in-possession, paid an additional premium (A.A. pp. 2187-2188), even though the bankruptcy court had authorized the issuance of that policy without the payment of a premium. If that ruling does not constitute a collateral attack, it is hard to imagine what would.

517, 519). Therefore, the bankruptcy court is clearly entitled to make orders regarding a debtor's insurance policy which favor "the debtor's continued existence" (slip opn., p. 43), even if, in the process, the rights of third parties are adversely affected.

By relying on state law rules that supposedly restrict an insurer's right to cancel an insurance policy, the Court of Appeal ignored the bankruptcy court's plenary power over the debtor's property. Regardless of what state law might provide, the bankruptcy court clearly had the power to approve the cancellation agreed to between National Union and Technical Equities. As the Ninth Circuit Court of Appeals explained in *In re Webber* (9th Cir. 1982) 674 F.2d 796:

> "The Constitution expressly confers on the Congress the power to establish uniform laws on bankruptcy throughout the nation. Generally, this authority 'includes the power to discharge the debtor from his contracts and legal liabilities as well as to distribute his property.' [Citation.] Thus, bankruptcy legislation has traditionally operated to affect creditors' interests which vested prior to the effective date of the legislation. [Citation.] Unlike the states, Congress is not prohibited from passing laws that impair contractual obligations. [Citations.] In fact, the very essence of bankruptcy laws is the modification or impairment of contractual obligations." (*Id.*, at p. 802, fns. omitted.)

National uniformity of bankruptcy law would be thwarted if a bankruptcy court's power to approve the cancellation of a debtor's insurance policy depended on

the law of the state in which the bankruptcy court happened to sit. (See *Gonzales v. Parks, supra,* 830 F.2d at p. 1035 ["The ability collaterally to attack bankruptcy petitions in the state courts would . . . threaten the uniformity of federal bankruptcy law, a uniformity required by the Constitution"].)

Review should be granted to clarify that a state court cannot rely on state law to disregard a final bankruptcy court order disposing of a debtor's property.

D. The Notice Of The Bankruptcy Hearing Satisfied Constitutional Due Process Requirements.

The Court of Appeal also held the bankruptcy court order was not entitled to full faith and credit because the notice to the directors and officers was "constitutionally inadequate." (Slip opn., p. 41; see also *id.*, at p. 42.) However, the federal courts uniformly hold that any notice that a bankruptcy court hearing will affect a person's interests is sufficient to meet constitutional due process standards, and persons receiving such notice ignore the proceedings at their peril. (*Matter of Gregory* (9th Cir. 1983) 705 F.2d 1118, 1123 [although notice of a bankruptcy court hearing "was not unambiguous," it satisfied constitutional due process standards and the bankruptcy court order could not be challenged in a subsequent action. "When the holder of a large, unsecured claim . . . receives any notice form the bankruptcy court that its debtor has initiated bankruptcy proceedings, it is under constructive or inquiry notice that its claim may be affected, and it ignores the proceedings to which the notice refers at its peril . . . "]; *In re Price* (9th

Cir. 1989) 871 F.2d 97, 99 ["(' . . . mere knowledge of a pending bankruptcy proceeding is sufficient to bar the claim of a creditor who took no action, whether or not that creditor received official notice from the court of various pertinent dates.')"]; *In re Coastal Alaska Lines, Inc.* (9th Cir. 1990) 920 F.2d 1428 [creditor aware of bankruptcy proceeding is put on inquiry notice and absence of notice of date within which to present claims therefore does not violate creditor's right to due process of law]; *Maher v. Zapata Corp.* (5th Cir. 1983) 714 F.2d 436, 452 [to comport with due process, a notice "need not explain . . . all the consequences involved in the settlement. It is not required to provide a complete source of settlement information. . . . " A notice is sufficient if it "implicitly invite[s] . . . a further investigation . . . on the basis for, the background of, and the legal implications of the settlement"]; *In re Lee Way Holding Co.* (S.D.Ohio 1990) 120 B.R. 881, 889-890 ["A notice under Bankruptcy rule 2002 is not intended or required to fully explain the circumstances of the case, the objections to a settlement, the circumstances surrounding settlement, or other details. PepsiCo should remember that this is a Notice, not a case history. . . . Furthermore, the Notice specifically stated that copies of the Trustee's Motion and the proposed settlement agreement could be obtained from the Trustee's counsel"].)

The notice of the hearing at which the bankruptcy court approved the cancellation of the D&O policy issued to Technical Equities clearly satisfied constitutional due process requirements. It informed the directors and officers that: (1) the D&O policy would be canceled effective July 13, 1986; (2) National Union would refund all

unearned premiums; (3) National Union would issue a successor D&O policy and provide extended discovery under the canceled policy at a cost which equaled the unearned premium due to Technical Equities; (4) the successor policy would cover acts of the directors and officers occurring on and after February 7, 1986, provided that claims under the successor policy were made between July 13, 1986 and July 13, 1987; (5) the limit of liability under the successor policy would be $5 million; (6) the officers and directors had the right to obtain such further insurance coverage or additional protection as they deemed necessary other than under the canceled D&O policy or the successor policy; (7) the motion, which set forth the complete terms of the compromise, was on file with the court, and included a copy of the D&O policy and a draft of the successor policy. (Ex. 4239.)

By advising the directors and officers that the existing D&O policy would be canceled, resulting in the refund of an unearned premium, and that the directors and officers could purchase such additional insurance coverage as they deemed necessary, the notice apprised them that their rights could be affected by the outcome of the hearing and that they ignored it at their peril. Like the notice in *Maher v. Zapata Corp., supra*, 714 F.2d at page 452, the notice here "implicitly invited . . . a further investigation . . . on the basis for, the background of, and the legal implications of the settlement." If the directors and officers had made any inquiry following receipt of that notice, i.e., if they had examined the motion itself, which included a copy of the D&O policy, they would have discovered what, if anything, they needed to do to

protect their interests. (*Matter of Gregory, supra,* 705 F.2d at p. 1123.)[9]

Further, we are unaware of any precedent authorizing a collateral attack on *a federal court* order in a subsequent *state court* action, regardless of the adequacy of the notice of the federal court proceeding. Even a void order can be set aside in federal court under rule 60(b) of the Federal Rules of Civil Procedure, so long as the aggrieved party acts within a reasonable time after learning of the order. Alternatively, the aggrieved party can file an independent action in federal court. Given the ready availability of relief in federal court, collateral attacks in state court on federal court orders should not be countenanced. (See Rest.2d Judgments, § 78, p. 229, com. a ["[T]he principle that equity will not grant relief when there is an adequate legal remedy implies that relief must ordinarily be sought through a 60(b) type of motion in preference to these other procedures. [¶] In broader context, preference for the motion procedure is an expression of the principle of comity among courts. The principle is that a court should not assume to disturb another court's disposition of a controversy unless there are good reasons for doing so. The principle is a guideline rather than a rule of jurisdiction, *though in application between courts of different judicial systems it may have jurisdictional significance*" (emphasis added)]; see also 7 Moore's Federal

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[9] Moreover, any *procedural* defects in either the content or timing of the notice (there were none) would not permit a collateral attack on the bankruptcy order. (*Union Joint Stock Land Bank v. Byerly* (1940) 310 U.S. 1, 7-8 [84 L.Ed. 1041, 1046, 60 S.Ct. 773].)

Practice (2d ed. 1992) ¶ 60.40, pp. 60-412 – 60-413 [stating that in light of the United States Supreme Court's decision in *Donovan v. Dallas* (1964) 377 U.S. 408 [12 L.Ed.2d 409, 84 S.Ct. 1579], there is "grave doubt" whether a state court has the power to give relief of any kind from a federal court judgment and "a litigant would be safer in seeking relief under Rule 60(b) or an independent action in the federal court"].) Therefore, regardless of whether the directors and officers received adequate notice, the bankruptcy order was not subject to collateral attack in state court.

E. The Bankruptcy Court Order Was Binding On Both The Directors And Officers And The Plaintiff Investors.

As we have shown, the directors and officers received constitutionally adequate notice of the bankruptcy hearing and that order cannot be collaterally attacked in state court in any event. Therefore, the directors and officers are bound by the order canceling the policy and, to the extent that the plaintiff investors assert claims against National Union as assignees of the directors and officers, they are also bound by that order. (*Woolett v. American Employers Ins. Co.* (1978) 77 Cal.App.3d 619, 625.)

In addition, plaintiffs are bound by that order to the extent they assert claims against National Union in their own right. This is so because they were in privity with persons who were parties to the bankruptcy proceedings. "A person technically not a party to the prior action may be bound by the prior decision if his interests are so

similar to a party's that that party was his 'virtual representative' in the prior action. [Citations.] A finding of virtual representation may be based on an express or implied legal relationship that makes a party to the prior action accountable to a non-party." (*United States v. Geophysical Corp* (9th Cir. 1984) 732 F.2d 693, 697.)

For example, among the persons present at the bankruptcy hearing who served as a "virtual representative" of the plaintiff investors was counsel for a class of plaintiffs who had filed a class action against the directors and officers. (Ex. 4111.) That counsel, as representative of a purported class which presumptively included all persons with claims against the directors and officers, owed fiduciary duties to all plaintiff investors. (See *City of San Jose v. Superior Court* (1974) 12 Cal.3d 447, 464 ["This court has long been concerned with requiring the representative party to protect the interests of the absent class members. . . . To fulfill this fiduciary duty the representative plaintiff must raise those claims 'reasonably expected to be raised by the members of the class' "]; 1 Moore's Federal Practice, Manual for Complex Litigation Second (2d ed. 1986) § 30, pp. 195-196 ["The attorneys and parties seeking to represent the class assume fiduciary responsibilities to the class"].)

In addition, counsel for the unsecured creditors committee was present at the bankruptcy court hearing. (Ex. 4111) Like counsel for a plaintiff acting as a representative of a class, counsel for an unsecured creditors committee "undertakes to act in a fiduciary capacity on behalf of the members of the class he represents." (*In re Johns-Manville Corp.* (S.D.N.Y. 1983) 26 B.R. 919, 924.)

The Court of Appeal held that counsel for the uncertified class and for the unsecured creditors committee did not adequately represent the interests of all investor plaintiffs because, although they were present, they did not actively participate in the proceeding. (Slip opn., pp. 45-46.) However, the class plaintiffs, the unsecured creditors committee and the remaining investor plaintiffs all had the identical interest in establishing as much insurance as possible to cover claims against the directors and officers. The cancellation had the identical impact on each of them. If it was in the best interest of the investors present at the hearing, it is "a fair inference" that it was in the best interest of the remaining investors as well. (*See Matter of Met-L-Wood Corp., supra,* 861 F.2d at pp. 1017-1018.) Moreover, we are unaware of any precedent, and none was cited by the Court of Appeal, for the proposition that a person is not bound by a judgment in a prior proceeding attended by that person's "virtual representative" if the representative chooses to remain silent. In addition, the Court of Appeal's conclusion that counsel for the unsecured creditor's committee was an uninterested bystander is wrong. He expressly approved the form and content of the order canceling the policy. (Ex. 4031.)

Further, for the Court of Appeal to hold that a bankruptcy court may not exercise its power to make dispositions of the estate's property because of the possibility of future claims by as yet unknown claimants ignores the in rem nature of the bankruptcy court proceeding. (See *Matter of Met-L-Wood Corp., supra,* 861 F.2d at p. 1017 [an order approving a bankruptcy sale "is an *in rem* proceeding. It transfers property rights, and property rights are

rights good against the world, not just against parties to a judgment or persons with notice of the proceeding" (original emphasis)].)

II.

THE COURT OF APPEAL ERRONEOUSLY HELD THAT NATIONAL UNION VIOLATED THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING.

A. An Insurer That Acts In Reliance On A Court Order Cannot Violate The Implied Covenant.

Acts undertaken with the approval of a court or public authority are not wrongful. (*Signal Oil, etc. Co. v. Ashland Oil etc. Co.* (1958) 49 Cal.2d 764, 782 ["[W]e . . . compel respect of an order of a California court which was valid on its face, and *we refuse to allow a party who acted in reliance on such order to be deprived of substantial rights . . . "]; Hayward Lumber & Inv. Co. v. Biscailuz* (1957) 47 Cal.2d 716, 723 [marshal not liable for acts taken in reliance on court order valid on its face]; *San Diego Coast Regional Com. v. See The Sea, Limited* (1973) 9 Cal.3d 888, 893 ["unjust" to require developer to obtain permit from newly created coastal commission where developer commenced construction project in reliance on city's prior issuance of building permit].)

The foregoing authorities dealt with acts taken in reliance on state court orders or other official acts. A *fortiori*, a state court should not hold that an insurer who cancels a policy in reliance on a *federal* court order violates the implied covenant of good faith and fair dealing. State courts must exercise discretion in determining the scope and effect of a federal court order. (See *Clark's Fork*

Reclamation Dist. v. Johns (1968) 259 Cal.App.2d 366, 369; *Williams Natural Gas Co. v. City of Oklahoma City* (10th Cir. 1989) 890 F.2d 255, 265, fn. 11 [" 'unthinkable to suggest that state courts should be free to disregard the judgment of federal courts' "].) For a state court to suggest a federal court has condoned a violation of the implied covenant raises serious issues of federal/state jurisdiction and comity.

The Court of Appeal cited two cases where insurers were found to have wrongfully canceled a policy. (*Spindle v. Travelers Ins. Companies* (1977) 66 Cal.App.3d 951, 958; *Home Ins. Co. of New York v. Heck* (1872) 65 Ill. 111.) In neither case, however, did any court, let alone a federal court, approve the cancellation. This court should grant review to make clear that an insurer cannot violate the implied covenant where it has acted in reliance on a court order.

* * *

Bernard Shapiro, a Professional Corporation
Lawrence Peitzman/Howard J. Weg/Clarisse W. J. Young
GENDEL, RASKOFF, SHAPIRO & QUITTNER
1801 Century Park East, Sixth Floor
Los Angeles, California 90067
(213) 277-5400

Attorneys for Debtor and Debtor in Possession

UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

In re TECHNICAL EQUITIES CORPORATION, Debtor.	Case No. 3-86-00366-LK Chapter 11 Date: July 28, 1986 Time: 9:30 a.m. Place: Courtroom 15427 (Judge Lloyd King) 450 Golden Gate Avenue San Francisco, California

NOTICE OF HEARING ON MOTION FOR AN ORDER APPROVING COMPROMISE OVER DIRECTORS AND OFFICERS LIABILITY AND CORPORATION REIMBURSEMENT INSURANCE POLICY

(Filed July 11, 1986)

TO ALL INTERESTED PARTIES:

PLEASE TAKE NOTICE that on July 28, 1986, at 9:30 a.m., a hearing will be held before the Honorable Bankruptcy Judge Lloyd King, Courtroom 15427, 15th Floor, 450 Golden Gate Avenue, San Francisco, California, with

respect to the Motion For An Order Approving Compromise Over Directors and Officers Liability And Corporation Reimbursement Insurance Policy ("the Motion") filed by Technical Equities Corporation ("TEC"), debtor and debtor in possession.

The essential facts and terms of the Motion are as follows:

1. On August 17, 1984, National Union Fire Insurance Company of Pittsburgh, P.A. ("National Union") issued to TEC a Directors and Officers Liability and Corporation Reimbursement insurance policy (the "Policy") for the period August 5, 1984 to August 5, 1987. TEC paid the entire premium due for the three years covered by the Policy, which contained a $10,000,000 liability limit, subject to specified terms and conditions.

2. On February 7, 1986, TEC filed its voluntary petition for relief under chapter 11 of the Bankruptcy Code.

3. National Union thereafter sent to TEC a letter which stated that the Policy was to be canceled effective June 20, 1986 and which denied the existence of coverage for the acts of the officers and directors of TEC, as a debtor in possession.

4. TEC and its attorneys responded to the purported notice of cancellation by making National Union aware that it was TEC's position that the acts of the officers and directors of TEC, as a debtor in possession, were covered by the Policy and that any cancellation of the Policy would be a violation of the automatic stay set forth in 11 U.S.C. §362(a). National Union disputed TEC's position and maintained that cancellation of the Policy

would not violate the automatic stay. The effective date of the notice of cancellation was extended by agreement to July 13, 1986, and then tolled pending the entry of an order granting the Motion to give the parties an opportunity to resolve their differences.

5. Litigation over the foregoing dispute would be time consuming and expensive. TEC and National Union have agreed to compromise the dispute. The compromise set forth in the Motion is in the best interest of the estate and creditors. However, all parties, including TEC's officers and directors, have the right to obtain such further insurance coverage or additional protection as they may deem necessary other than under the Policy or the Successor Policy, subject to the requirements of the Bankruptcy Code and the Bankruptcy Rules. The terms of the compromise, as set forth in the Motion, include the following:

(a) TEC shall agree that the Policy has been canceled effective July 13, 1986, and National Union shall thereupon refund to TEC all unearned premiums due under the Policy.

(b) National Union shall agree to issue a new Directors and Officers Liability and Corporation Reimbursement Policy insurance policy (the "Successor Policy") and to provide one year extended discovery pursuant to the terms of the Policy at a cost which equals the premium refund due to TEC, described above in paragraph 5(a). The Successor Policy will cover acts of the officers and directors of TEC as debtor and debtor in possession occurring from and after February 7, 1986,

provided that claims under the Successor Policy are made during the period July 13, 1986 to July 13, 1987.

(c) The limit of liability under the Successor Policy shall be $5,000,000.

(d) The Successor Policy will also cover the reorganized entity for an additional premium of $10,000, if TEC confirms a plan of reorganization which becomes effective during the term of the Successor Policy.

The complete terms of the compromise are set forth in the Motion. Copies of the Motion and the exhibits thereto, including the Policy and a draft of the Successor Policy, are on file with the court.

Any interested party that objects to the Motion must file with the court and serve on the attorneys for TEC written notice of any objections and copies of all evidence in support thereof within ten (10) days after service of this notice.

Mailing Date: July 8, 1986

GENDEL, RASKOFF, SHAPIRO & QUITTNER

By /s/ Howard J. Weg
Howard J. Weg
Attorneys for Technical Equities Corporation, Debtor and Debtor in Possession

Bernard Shapiro, a Professional Corporation
Lawrence Peitzman
Howard J. Weg
Clarisse W. J. Young
GENDEL, RASKOFF, SHAPIRO & QUITTNER
1801 Century Park East, Sixth Floor
Los Angeles, California 90067
(213) 277-5400

Attorneys for Debtor and Debtor in Possession

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re TECHNICAL EQUITIES CORPORATION, Debtor.	Case No. 3-86-00366-LK Chapter 11 Date: July 28, 1986 Time: 9:30 a.m. Place: Courtroom 15427 (Judge Lloyd King) 450 Golden Gate Avenue San Francisco, CA

ORDER APPROVING COMPROMISE OVER DIRECTORS' AND OFFICERS' LIABILITY AND CORPORATION REIMBURSEMENT INSURANCE POLICY

(Filed Aug. 5, 1986)

On July 28, 1986, Technical Equities Corporation ("TEC"), Debtor and Debtor in possession in the above-captioned Chapter 11 case, brought on for hearing its "Motion for an Order Approving Compromise Over Directors' and Officers' Liability and Corporation Reimbursement Insurance Policy" (the "Motion").

TEC was represented at the hearing by Lawrence Peitzman of the law firm of Gendel, Raskoff, Shapiro & Quittner and George Yuhas of the law firm of Orrick, Herrington & Sutcliffe. The Unsecured Creditors' Committee in TEC's Chapter 11 case was represented by James L. Lopes and Michael Eagan of the law firm of Howard, Rice, Nemerovski, Canady, Robertson & Falk.

Other parties in interest represented at the hearing were: General Electric Credit Corporation, represented by Margaret Sheneman of the law firm of Murphy, Weir & Butler; Security Pacific National Bank, represented by Karen L. Heilman of the law firm of Lillick, McHose & Charles; Bank of the West, represented by Gary Nemer of the law firm of Buchalter, Nemer, Fields, Chrystie & Younger; and certain class action plaintiffs, represented by George Donaldson of the Law Offices of David B. Gold.

The Court considered all papers filed by TEC in connection with the Motion and statements made by counsel for TEC at the hearing. No objections to the Motion were filed with the Court or stated at the hearing.

The Motion having been duly served in accordance with prior orders of this Court, and good cause appearing, it is

ORDERED that the Motion is granted and specifically that

A. Adequate notice of the Motion and the hearing was provided to all parties entitled thereto;

B. The proceeding with respect to the Motion is a core proceeding within the meaning of 28 U.S.C. Section 157(b)(2)(a);

C. The compromise described in the Motion, including cancellation of the Policy subject to issuance of the Successor Policy, is approved as being in the best interest of the estate and creditors;

D. All parties, including TEC's officers and directors, have the right to obtain such further insurance coverage or additional personal protection as they may deem necessary other than under the Policy or the Successor Policy, subject to the requirements of the Bankruptcy Code and the Bankruptcy Rules.

DATED: 5 AUG 1986

LLOYD KING
BANKRUPTCY JUDGE

Approved As To Form
Howard, Rice, Namerovski,
Canady, Robertson & Falk

By /s/ James L. Lopes
James L. Lopes
Attorneys for The Unsecured
Creditors' Committee

EXCERPT FROM JURY INSTRUCTIONS, *McLaughlin v. National Union*

INSTRUCTION NO. 31

"There has been a prior determination and you are instructed to consider the following as conclusively proven:

* * *

"4. Cancellation of the third year of the D&O policy was invalid, and had no effect on plaintiffs herein, a bankruptcy order to the contrary notwithstanding."

(3)

Supreme Court, U.S.
JUL 22 1993
OFFICE OF THE CLERK

No. 92-1974

In The

Supreme Court of the United States

October Term, 1993

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA,

Petitioner,

vs.

LEONARD HELFAND and EILEEN HELFAND,

Respondents.

On Petition For A Writ Of Certiorari To The California Court Of Appeal, First Appellate District, Division Four

BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

COTCHETT, ILLSTON & PITRE
JOSEPH W. COTCHETT
SUSAN ILLSTON
MARIE SETH WEINER*
San Francisco Airport Office Center
840 Malcolm Road, Suite 200
Burlingame, CA 94010
(415) 697-6000

THOMAS T. ANDERSON & ASSOCIATES
THOMAS T. ANDERSON
45-926 Oasis Street
Indio, CA 92201-4591
(619) 347-3364

Attorneys for Respondents

*Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

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I. QUESTIONS PRESENTED FOR REVIEW

Whether, consonant with its obligation to give full faith and credit to a judgment or final order of a federal court, a state court may determine, based upon its review of the facts and circumstances attendant to entry of a federal bankruptcy order approving a compromise, whether that federal order should be given preclusive or *res judicata* effect as to parties before the state court who were not parties in the bankruptcy proceeding and were not parties to the "compromise".

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II. OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Petitioner National Union argued below – correctly – that the California state court *did have* jurisdiction to determine the full faith and credit and *res judicata* effects of the Bankruptcy Court order. Having urged the California court to make the *res judicata* determination, petitioner now finds that it does not like the *result* it received. Recognizing, as it must, the futility of asking this Court to retry the factual issues that gave rise to that result, petitioner now rotates 180 degrees and asserts that the state court had no subject matter jurisdiction after all.[1]

Petitioner's about-face to recast the question as one of subject matter jurisdiction is certainly understandable since the case below presents no substantially controverted issue relating to the federalism precepts of either full faith and credit or *res judicata*. What the California court did below is perfectly consistent with, not only the teachings of this Court, but with the manner in which the *res judicata* effects of prior federal orders are determined by other federal and state courts throughout the land.

In attempting to manufacture grounds for *certiorari*, National Union frames a jurisdictional dispute where none existed, and seeks to portray an unconstitutional encroachment upon federal jurisdiction. To the contrary, the federal and state courts below exercised admirable deference to the jurisdiction of each other, each acting where it should act, and each giving due regard to the

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[1] *E.g.*, Petition at 14: "The California courts clearly lacked subject matter jurisdiction . . . "

acts of the other. At every turn, petitioner National Union sought to have either the district court or the bankruptcy court interfere with this and related litigation in the California court. On each occasion, the federal court declined National Union's application and, indeed, the bankruptcy court specifically found that the California court was the proper forum to adjudicate issues of interpretation of the insurance policy and insurance coverage – the precise issues decided by the California court below.[2]

This Court is faced here with a straightforward legal issue: Although giving full faith and credit to a prior bankruptcy order, does the state court have power to then determine the *res judicata* effect of that order upon a litigant who urges that he was not a party to the prior bankruptcy proceeding, and thus is not bound by it? Certainly a state court has the jurisdictional power to do this. *E.g., Parsons Steel v. First Alabama Bank*, 474 U.S. 518 (1986) (Rehnquist, J., for unanimous court). None of the factors implicating the grant of *certiorari*, as set forth in Rule 10 of this Court, is present here. What remains is the issue of whether the California court made a correct *factual* determination of whether respondents here were, in fact, parties before the bankruptcy court. Review of that fact specific determination, amply supported by the record, is certainly not grist for this Court's mill.

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[2] *See* Part II(A), *infra*.

III. STATEMENT OF THE CASE

The complex nature of the facts supporting the California court's[3] determination that respondents herein were not "parties" to the bankruptcy proceeding are set forth in some detail in the opinions below. To the extent possible, we will not reiterate those facts here, but will focus upon important aspects of the case about which petitioner's discussion here has been incomplete or incorrect.

A. Petitioner's Attempted Characterization To The Contrary Notwithstanding, The Federal And State Courts In This Action Exhibited Exemplary Deference To Each Other's Jurisdiction

In an attempt to construct a rationale for *certiorari*, petitioner National Union here describes a state court that has flouted the jurisdiction of a bankruptcy court. In point of fact, however, the bankruptcy court itself had specifically determined that the California court should render all decisions regarding the interpretation of the subject insurance policy and the issue of insurance coverage for various state court claimants, including respondents Helfand. Indeed, both the federal and state courts were well aware of the jurisdiction being exercised by the other. Petitioner National Union, at every opportunity, sought relief from the United States District Court and

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[3] For ease of reference, the term the "California court" refers to the Court of Appeal, and its holding and opinion affirming the trial court judgment below "insofar as it declares there is $10 million in coverage for third year claims." Petitioner's Appendix ("PA") at 52a.

the United States Bankruptcy Court, each time attempting to divest the state court of jurisdiction. As is described below, on all occasions the district court and the bankruptcy court rejected petitioner's importunings, and allowed this case and related litigation to continue in state court.

Shortly after this *Helfand* action was filed in state court, petitioner removed it to the district court, arguing that its relationship to the bankruptcy case provided federal jurisdiction. The district court disagreed, and remanded the case. Respondents' Appendix ("RA"), at A1-A4. Thereafter, National Union interpled a bond for $10 million in the bankruptcy court and sought an injunction from the bankruptcy court enjoining prosecution of this case as well as other state court related litigation. The bankruptcy court refused to enjoin this state court litigation, recognizing that issues of insurance coverage were properly before the state court, and that there was no predominant federal interest justifying an injunction.[4] The bankruptcy judge recognized that wide-ranging and complex litigation required a "strong judicial hand", but, in this case, deferred to the state court to provide that judicial leadership. RA A10. The bankruptcy judge further recognized that the bankruptcy estate was simply a claimant against the insurance policy along with hundreds of others, such as the respondents, and expressed

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[4] Indeed, prior to National Union's filing of an interpleader adversary proceeding, in its October 5, 1987 order granting relief from the automatic stay, the bankruptcy court expressly determined that all issues of insurance coverage should be determined by the state court in this *Helfand* action. PA 81a.

doubt whether the insurance proceeds were property of the estate. RA A8-A10; *see, In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1399-1400 (5th Cir. 1987) (holding that D&O policy proceeds are *not* the property of the bankruptcy estate of the corporation, but rather the property of the insured directors and officers). Indeed, the Bankruptcy Court always deferred, and later formally abstained, in favor of the state court, from deciding any issue involving interpretation of the insurance policy or limits of coverage. RA A14-A15.

After judgment was entered at the trial court in this matter, petitioner returned to the district court seeking an injunction enjoining respondents from enforcing the judgment below. PA 29a. In denying the injunction, in a 12-page Memorandum of Decision, RA A12-A23, the district court identified the controlling issue as being *res judicata* of the bankruptcy order and the controlling questions – including notice, representation and privity – as having been presented to and decided by the state court below. The district court rejected National Union's application for injunction, finding that it would "be an unwarranted and unconscionable intrusion upon the California processes, wholly at odds with governing principles of federalism, comity, and equity." RA A22.

In its opinion, the district court recognized that the fact situation was "murky" and implied strongly that the reason petitioner sought not to go to the bankruptcy court with its latest request for injunction was because the state court had done exactly what the bankruptcy

court had contemplated – decide insurance policy interpretation and coverage issues.[5]

National Union appealed the district court's decision. The Ninth Circuit summarily affirmed that decision and dismissed National Union's appeal. PA 29a.

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[5] The district court's opinion noted:

> The factual situation is rendered more murky than otherwise by the fact that the bankruptcy court judge, King, C.J., rendered subsequent decisions which strongly indicate that he had no intention of effecting matters of coverage, policy limits and the like, but was leaving such determinations to the state court judge who was presiding over the state coordinated proceedings.
>
> For example on July 28, 1986 King approved the compromise over the D&O policy. On October 30, 1987 National Union sought a preliminary injunction from Judge King, enjoining the then ongoing state and federal actions. This request was refused. On April 29, 1988 National Union sought a Finding that the Order of July 28, 1986 had limited coverage under the D&O Policy to $10 million. This, and the accompanying motion for preliminary injunction of ongoing state and federal court litigation, were denied by King on June 22, 1988. . . .
>
> . . . [O]n September 7, 1990, King tentatively granted the *Helfand* plaintiffs motion for complete abstention from determination of all remaining issues in the interpleaded action. This order was conditioned only upon the finding of a suitable mechanism to distribute the interpleaded funds.
>
> All this causes me to wonder why plaintiffs [National Union] chose this district court in which to seek injunctive relief rather than the bankruptcy court which made the order whose preclusive effect is in issue here.

RA A14-A15.

B. National Union's Unilateral Cancellation Of The Policy Constituted Bad Faith Vis-A-Vis Respondents, Notwithstanding Any Later Compromise Reached By National Union And TEC

1. Once Injury Had Occurred, Respondents Had A Personal Interest In The Third Year Coverage Of The Policy

Fundamental to this declaratory relief action is the proposition that an insurance company may not unilaterally and arbitrarily cancel a liability policy, particularly when injured persons have claims against that liability policy. California law in this regard was settled in an opinion written for the California Supreme Court by Justice Traynor. *Shapiro v. Republic Indemnity Co. of America*, 52 Cal. 2d 437 (1959). The facts were not dissimilar from this case. After an accident had occurred, the insurance company and the insured filed suit in state court for a decree of reformation. The reformation of the policy was such that it would have meant the injured party's claim was not covered. After receiving a judgment against the insureds, the injured party then sued the insurance company to recover the judgment. The insurance company defended on the basis that the judgment in the reformation action between it and the insured was *res judicata*. Just as did respondents in this case, the injured plaintiff in *Shapiro* argued that she was not bound by the judicial judgment of reformation, because she was not a party to that litigation. Discussing cases from around the country, including the federal decision of *New Amsterdam Casualty Co. v. Murray*, 242 F.2d 549 (6th Cir. 1957), the California Supreme Court observed that:

> [T]he injured person's rights against the tort feasor's insurer arise upon the happening of the accident and cannot thereafter be abridged by a judgment to which the injured person is not a party. A judgment cancelling the policy . . . was held not to be binding on the injured person. [Citations.] (52 Cal. 2d at 440.)

Thus, in refusing to give *res judicata* effect to the judgment of reformation, the California Supreme Court in *Shapiro* found that the injured persons "had an interest [in the liability policy] that could not be altered or conditioned by independent action of the insurer and the insured. [Citation.] Nor can these rights be conclusively determined against the injured persons in an action to which they were not made parties." 52 Cal. 2d at 440.[6]

2. It Was National Union's Unilateral Decision To Cancel The Policy And Frustrate Respondents' Interest In The Policy That Was Held To Be Arbitrary And In Bad Faith, Not National Union's Participation In A Compromise Between National Union and TEC

Without regard for the rights of injured parties in the policy, National Union unilaterally "cancelled"[7] the third

---

[6] Accord, *General Insurance Company of America v. Whitmore*, 235 Cal. App. 2d 670, 674 (1965); *General of America Insurance Company v. Lilly*, 258 Cal. App. 2d 465, 472 (1968); *see also, Courtney v. Waring*, 191 Cal. App. 3d 1434, 1448 (1987).

[7] We use "cancelled" because the California court applying California law held that National Union's decision to cancel the D&O policy was "arbitrary" and "without legal justification", and thus improper, such that coverage exists under the third policy year. PA 29a, 49a, 50a, 86a.

year coverage of the policy. National Union did this *without prior notice* to TEC, and certainly without any Bankruptcy Court approval. As is detailed in some length in the opinion of the Court of Appeal, under California law, an insurance company does not have an unfettered right to cancel coverage, notwithstanding a mutual cancellation clause to that effect. PA 46a-51a. Any cancellation by an insurance company is subject to the requirements of the implied covenant of good faith and fair dealing. *Spindle v. Travelers Ins. Companies,* 66 Cal. App. 3d 951, 957-958 (1977).

The Court of Appeal examined in some detail the evidence demonstrating that National Union's cancellation was arbitrary, and that National Union, by attempting to cancel unilaterally, sought to exalt its interest above the interests of the insureds and the injured parties. The California court found the attempt at cancellation without justification, in part, because it was based upon mere allegations of fraud at TEC that were not verified, and because the attempt at cancellation sought to divest all insured directors and officers of TEC of their liability coverage, even though there was no suspicions that most of the insureds, especially the "outside directors" had committed any fraud.[8] PA 48a-49a. And finally,

---

[8] Technical Equities gave written notice of potential claims to National Union by letter dated January 30, 1986. PA 65a. Technical Equities filed for Chapter 11 protection under the bankruptcy laws on February 7, 1986. PA 66a. Commencing at that time, hundreds of individual lawsuits by hundreds and hundreds of T.E. investors and clients were filed against the TEC officers and directors in California state court, including a lawsuit by respondents and plaintiffs Leonard and Eileen Helfand.

the California court recognized that a cancellation of a prepaid policy when loss is "imminent and unavoidable" is not in good faith.[9] PA 50a-51a.

In March 1986, without consulting with TEC and certainly without the approval of the bankruptcy court, National Union decided to cancel Technical Equities' prepaid 1984-1987 D&O policy. PA 47a. National Union admitted that it knew that TEC had prepaid its premiums on the three-year policy, that lawsuits were pending against TEC officers and directors who were insureds under the D&O policy, that additional lawsuits would be filed against the insureds, and that these were significant monetary claims against the insureds. PA 47a.

According to *National Union* the sole reason for cancellation of the D&O policy was that its senior underwriter had a " 'gut feel[ing]' that some individuals at Technical Equities were 'guilty of gross fraud.' " PA 47a-48a. His understanding concerned one to five individuals; he was not aware of any information indicating that the two dozen other T.E. officers and directors, including the outside directors, who were also insureds under the D&O policy, were engaged in "gross fraud". PA 48a. As National Union admitted, if "gross fraud" had been committed by any of its insureds, those acts would be *excluded* from coverage, and there would have been no need to cancel the policy. PA 48a. Allowing the policy exclusions to take effect would have allowed coverage to continue as to the other "innocent" insureds who were not known or suspected of having committed any wrongful acts at the time of cancellation. "Nonetheless, he still felt a need to cancel the policy because they 'weren't sure where the corporation was going' and 'what was going to occur going forward.' " PA 48a.

There was no factual investigation undertaken by anyone at National Union prior to the cancellation. PA 48a. The "reason for cancelling was not communicated to anyone involved in or affected by the cancellation, including National Union's own staff, Technical Equities, the insured directors and officers, and the insurance broker." PA 49a.

[9] For example, the California court cited, at PA 50a, a venerable case where the insurer gives notice of cancellation when

This does *not* mean that the California court determined that the bankruptcy order approving the compromise between TEC and National Union was invalid. To the contrary, after TEC had raised with National Union the argument that National Union's "cancellation" was invalid as violative of the automatic bankruptcy stay of 11 U.S.C. §362, National Union and TEC bargained. *They* reached a compromise. The D&O liability policy contains two parts, one of which provides coverage to injured parties such as respondents Helfand, the other provided TEC, the corporation, with the right to receive reimbursement from National Union for claims paid by it on behalf of the officers and directors (the "corporation reimbursement" portion). PA 2a, 55a, 80a. In its bargain with National Union, TEC gave up *its* right to claim under the corporation reimbursement portion for up to $10 million in coverage for indemnification payments made to the directors and officers in the third year of the policy. In return, TEC received, and National Union provided, a $5 million policy covering post-bankruptcy acts.

Thus, whether or not National Union had the unilateral right to cancel its third year obligations to TEC (as opposed to the respondents), the bargain that TEC and National Union reached was certainly a matter that the Bankruptcy Court could approve. On the other hand, as

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fire is approaching the insured property: "Of what avail would it be, to take a policy against fire, to permit its cancellation when fire is approaching?" *Home Ins. Co. v. Hecht*, 65 Ill. 111, 114 (1872). *See also, Harman v. American Casualty Co. of Reading, Pa.*, 155 F. Supp. 612, 613-614 (S.D. Cal. 1975) ; *Murphy v. Seed-Roberts Agency, Inc.*, 79 Mich. App. 1 (1977); *L'Orange v. Medical Protective Company*, 394 F.2d 57 (6th Cir. 1968).

the California court found, the cancellation and replacement of the cancelled policy with a new policy covering post-bankruptcy acts could benefit National Union and could benefit TEC, but was of absolutely no benefit to parties, such as respondents here, who were damaged by pre-bankruptcy acts, or to the insured directors and officers who would need the bargained-for and paid-for coverage for their pre-bankruptcy acts.

Contrary to National Union's mischaracterization, the decisions below, fairly read, do not hold National Union in "bad faith" for participating in the bankruptcy court process approving the compromise between TEC and National Union. To the contrary, it was National Union's unjustified and arbitrary "cancellation" of the policy as it affected respondents' rights, which began months prior to the bargain approved by the Bankruptcy Court, that constituted bad faith on National Union's part.

IV. CERTIORARI SHOULD BE DENIED HERE BECAUSE THE LEGAL ISSUES RAISED BY THE PETITION ARE WELL ESTABLISHED, UNDISPUTED AND WERE CORRECTLY APPLIED BELOW

The real issue raised by this petition is the proper effect of a final order of a Bankruptcy Court upon subsequent state court litigation. Analysis of this issue raises two questions of federal law: (i) whether the state court is required to give full faith and credit to the Bankruptcy Court order, and (ii) whether in seeking to give full faith

and credit to that federal judgment, the state court is empowered to determine the scope of the binding effect of that order under the principles of *res judicata*.

These are, no doubt, important questions; but the significance of the questions has led to answers that are not, and, indeed, cannot be, controverted. The clear, consistent teaching of this Court is, and has been, that a state court *must* give full faith and credit to a final order of a Bankruptcy Court, *and* that the state court *does have* jurisdictional power to then determine the binding effect of the federal judgment upon the parties and issues before the state court.

The question presented by petitioner, whether a state court lacks subject matter jurisdiction to "nullify final order of a United States Bankruptcy Court" not only answers itself, but has no relevance to the proceedings below. The California court could not, and did not, nullify the Bankruptcy Court order; by the same token, the California court could, and did, decide whether that order was binding on litigants found not to be parties to the bankruptcy proceeding. Although *now* characterizing the state court's decision as an extra-jurisdictional encroachment upon federal law, *below* petitioner National Union recognized that the California court did have jurisdiction to act as it did.[10] Thus, in an attempt to manufacture an appropriate issue for *certiorari*, National Union

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[10] In arguing below that the California court *did have* subject matter jurisdiction to render a determination regarding the *res judicata* effect of the bankruptcy order, National Union demonstrates the thin contrived nature of its argument here that the California court exceeded its jurisdiction. Speaking of the same court that it here urges exceeded its jurisdiction, National Union

has come full circle, abandoning its argument below that the California court *should decide* the *res judicata* effect of the federal court's order, now arguing that the California court had no jurisdiction to do so.

Indeed, National Union below framed the issue in exactly the manner in which *respondents* frame it here. As National Union put the question to the California Court of Appeal:

> Therefore, the issue whether the bankruptcy court's order was entitled to full faith and credit and should be given res judicata effect in this action is squarely presented by this appeal. (PA 137a (Excerpts from Appellant's Opening Brief).)

National Union seeks to jettison the real issue, and substitute a contrived jurisdictional "end-run," because, in the context of this case, neither the application of the full faith and credit obligation nor the determination of the *res judicata* issue implicates "an important question of federal law which has not been, but should be, settled by this Court."[11]

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claimed below: "[I]ssue and claim preclusion arguments may be made in state court after the federal court declines to grant an injunction." PA 137a (citing *Golden v. Pacific Maritime Ass'n.*, 786 F.2d 1425, 1427 (9th Cir. 1986)).

[11] *See*, Rule 10.1(c) of Rules of the Supreme Court of the United States. Indeed, no other principle supporting the grant of *certiorari* is present here, such as a conflict of decisions between the circuits or between the circuit or the states.

A. The California Court Was Required To, And Did, Give Full Faith And Credit To The Bankruptcy Court Order

A final order of a Bankruptcy Court may be treated as a final judgment.[12] Thus, when that order was raised below as an affirmative defense by National Union, the doctrine of full faith and credit was implicated.

Although neither the full faith and credit clause of the Constitution, Article IV, Section 1, nor the full faith and credit statute, 28 U.S.C. §1738, directly addresses the issue, there "is a clearly established rule that state courts *must give full faith and credit* to the proceedings of federal courts[.] That this is the rule is *beyond doubt*. . . . "[13] Indeed, the concept that a state court must afford full faith and credit to a federal judgment is so fundamentally rooted in the concept of federalism that it is "unthinkable"[14] to even suggest that a state court could disregard a federal judgment. Throughout the land, state courts

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[12] Clearly the subject bankruptcy order is "final". The extent to which an Order Approving Compromise is a "judgment", particularly as the subject bankruptcy hearing was not a decision ending the litigation on the merits (*see*, PA 35a), is not of import herein. *Cf., Chicot County Drainage Dist. v. Baxter State Bank*, 308 U.S. 371 (1940); *Coastal Petroleum Co. v. U.S.S. Agri-Chemicals*, 695 F.2d 1314, 1319 (11th Cir. 1983). Accordingly, for purposes of the issue of *res judicata* herein, respondents concede that there is no distinction between a final order and a final judgment.

[13] Degnan, *Federalized Res Judicata*, 85 Yale L.J. 741, 744 (1976), emphasis added.

[14] 18 C. Wright, A. Miller & E. Cooper, *Federal Practice and Procedure*, § 4468, p. 648 (1981).

recognize their "obligation to honor federal judgments without cavil."[15] The law is certainly so in California: "Full faith and credit must be given to a final order or judgment of a federal court." *Levy v. Cohen*, 19 Cal. 3d 165, 172 (1977) (citations omitted.) This Court has consistently so held. *E.g., Stoll v. Gottlieb*, 305 U.S. 165, 170 (1938), and cases cited therein.

B. A State Court, While Affording Full Faith And Credit To A Prior Federal Judgment, Must Itself Determine The Scope And Effect Of That Judgment Upon The Parties And Issues Before It

Having determined that a state court must give full faith and credit to a federal judgment neither ends the analysis nor indicates that a state court may not play an important role in determining the binding effect of a prior federal judgment. Professor Degnan says it well:

> A doctrine that a judgment is binding, however, does nothing to delineate its scope. There remains the question of *what issues*, and *what persons*, are concluded or bound. (Emphasis added.)[16]

Those were the questions presented to the California court.[17]

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[15] 18 C. Wright, A. Miller & E. Cooper, *Federal Practice and Procedure, supra*, § 4468, p. 659.

[16] Degnan, *Federalized Res Judicata*, 85 Yale L.J. 741, 756 (1976).

[17] For example, National Union argued below that respondents were on constructive notice and were in privity with parties to the bankruptcy proceeding, and thus bound by its

The jurisdictional power of a state court to answer these questions and thus to determine the *res judicata* effect of a prior federal judgment is well ingrained in the law of federalism, including the decisions of this Court. For example, this unassailable concept was a foundation of this Court's unanimous decision in *Parsons Steel v. First Alabama Bank, supra,* 474 U.S. 518 (challenges to correctness of state court's determination of conclusive effect of federal judgment pursued by way of appeal through state court system and *certiorari* from this Court). Indeed, a state court's ability to make such determinations is so profound, within the concept of federalism, that *even if* the state court were absolutely wrong in its *res judicata*

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order; to the contrary, respondents argued that they had received no notice, made no appearance, and were not bound.

Indeed, at trial, counsel for National Union conceded that no attempt made to notify any of the injured third parties of the motion for order approving compromise, because National Union took the position that the injured plaintiffs had no rights in the D&O policy:

> The point is that plaintiffs were strangers to the [insurance] contract, and the plaintiffs had no rights under the D and O policy until they obtained judgments. And as of August of 1986 there were no judgments. Yes, they had an interest in the policy perhaps as any contingent claimant might have, but they had no right that they could demand to be notified.

RA A24-A25. However, the law makes it quite clear that, far from being "strangers" to the policy, respondents had interests in the liability policy which could not be annihilated without notice to them and an opportunity to be heard. *See* Part III(B)(1), *supra*.

conclusions, a "later" federal court would be *bound* to follow it.[18]

The manner in which the state court exercises its power to determine the preclusive effect of a prior federal judgment follows from the well-enunciated principles of *res judicata*. The touchstone is whether the party in the second suit, against whom preclusion is urged, was, in fact, a party to the first suit:[19]

> The basic premise of preclusion is that non-parties to a prior action are *not bound*. A non-party is *not precluded* from relitigating matters decided in a prior action simply because it passed by an opportunity to intervene. [Citations.] (*Valenti v. Mitchell*, 962 F.2d 288, 297 (3d Cir. 1992).)

Indeed the requirement that a party "against whom an estoppel is asserted had a full and fair opportunity to litigate is a most significant safeguard." *Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation*, 402 U.S. 313, 329 (1971).

The California court decided that the respondents were not parties to the bankruptcy litigation, had not

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[18] *E.g., Matter of Brady, Texas Mun. Gas Corp.*, 936 F.2d 212 (5th Cir. 1991) (state court gave clearly erroneous *res judicata* effect to prior bankruptcy court order, even so, federal court was bound to give *res judicata* effect to that erroneous state court decision).

[19] By use of the term "party" we do not mean here to short change the doctrines of "privity" and "virtual representation" as they apply in this context. This aspect of the *res judicata* doctrine was urged below by National Union, and was rejected, as a *factual matter*, by the California court. PA 43a-46a.

received adequate notice thereof, and did not appear therein. The California court thus concluded, as it must, that the federal order would not estop respondents from seeking to have their rights in the third policy year determined. In so doing, the California court did exactly as this Court counseled in *Blonder-Tongue, supra*:

> Some litigants – those who never appeared in a prior action – may not be collaterally estopped without litigating the issue. They have never had a chance to present their evidence and arguments on the claim. Due process prohibits estopping them despite one or more existing adjudications of the identical issue which stand squarely against their position. See *Hansberry v. Lee*, 311 U.S. 32, 40 (1940); *Bernhard*, 19 Cal 2d, at 811, 122 P. 2d, at 894. (402 U.S. at 329.)

Thus the California court's determination – whether or not factually correct – was hardly an intrusion into federal jurisdiction or an evisceration of the federal judgment. In its petition, National Union argues that respondents were required to have the bankruptcy court determine whether the bankruptcy order bound them. But such is not the law of *res judicata*. *E.g., Parsons Steel v. First Alabama Bank, supra*. Parties are free to seek to have their rights vindicated in the "second court" and it is that "second court" that determines the scope of the first court's judgment.

> Disputes about the effect of a decision in one case on the prosecution of another are for the judge presiding in the *second case*. In the law of preclusion the *second court* normally determines the effect of the first judge's order. [Citations.]

(*Pettibone Corp. v. Easley*, 935 F.2d 120, 123 (7th Cir. 1991), emphasis added.)

The baton is picked up by the second court, even when that court is a state court, reviewing the *res judicata* effects of a federal judgment. *E.g., Merle Norman Cosmetics, Inc. v. Victa*, 936 F.2d 466, 468 (9th Cir. 1991) (affirming district court view that state court was in best position to evaluate preclusive effect of a federal court judgment; state courts are just as capable as federal courts in applying applicable law).

C. The Approach Of The California Court Was Totally Consistent With The Law Of Federalism, And The Result Of Its Decision Is Fact Specific, And Not Appropriate For Review Here

Contrary to the assertions here by petitioner, the decision of the California court in no sense ignored the bankruptcy court order or declared it a nullity. Indeed, the trial court noted that the compromise cancelling the D&O policy and providing for issuance of a new $5 million DIP policy was certainly valid and effective as between TEC and National Union, to provide coverage for post-bankruptcy events. PA 88a-89a. Further, the California court rejected any invitation to hold that the bankruptcy court order was not effective as between the parties thereto, for example, because the cancellation had violated the automatic stay of 11 U.S.C. §362. PA 33a n. 13. Indeed, the California court recognized that *had* the plaintiffs before it been parties to the bankruptcy proceeding and received adequate notice of the motion, they *would have* been bound. PA 70a.

Thus, at the end of the day, the compromise was valid between TEC and National Union, but did not affect the rights of the respondents.[20] Pursuant to the bankruptcy court order, TEC was not entitled to make any claim for corporate reimbursement against the $10 million third year coverage, and in return, TEC received a $5 million one-year policy covering its post-bankruptcy acts. On the other hand, the Helfands, and others similarly situated, were not deprived of their ability to make claims against the third year coverage because (i) under state law, their interests in that third year had sufficiently ripened and (ii) those interests could not be extinguished by litigation to which they were not a party.[21]

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[20] In an analogous situation, the Ninth Circuit Court of Appeals rejected the argument that a third party's declaratory relief suit involved a collateral attack on a bankruptcy court order approving a settlement agreement between the debtor and its bank. Although recognizing that the bankruptcy court did authorize and approve the settlement, the Ninth Circuit pointed out:

> This argument much over-states what the order of the bankruptcy court did. The bankruptcy court authorized [the company] to settle with the Bank of America. It did not purport to determine the effect of the settlement on Teerlink's lots. . . . There was nothing in the agreement and a fortiori nothing in the order of the bankruptcy court that barred Teerlink from seeking the declaration the district court issued. . . . *[T]here was no determination by the bankruptcy court of what the legal consequence was . . .*

In re Teerlink Ranch Ltd., 886 F.2d 1233, 1236 (9th Cir. 1989), cited by California Court of Appeal at PA 34a.

[21] *See* discussion of *Shapiro v. Republic Indemnity Co. of America, supra*, 52 Cal. 2d 437, holding that injured parties' rights against proceeds of insurance policy could not be mod-

Thus, the California court discharged its jurisdictional power in precisely the manner contemplated by this Court in *Parsons* – it made a *res judicata* determination with respect to the federal judgment. In so doing, the California court announced no new law nor sought to change bankruptcy law or any other federal law. The court simply answered, in a factual way, the traditional questions of the *res judicata* analysis: Were the Helfands given a full and fair opportunity to appear in the bankruptcy court and protect their interests in the liability policy? Given that the Helfands received no notice, was the notice given to the insured officers and directors sufficient to put them on notice that *their interests*, as opposed to TEC's, would be compromised? Were the Helfands "privies" to those who were clearly parties before the bankruptcy court?

Answering these questions, the California court focussed upon a number of factors peculiar to this case. For example, in determining the adequacy of notice to the respondent Helfands, the California court analyzed, in detail, a complicated factual pattern involving various persons whose "interrelationships" were the source of hot debate.[22] In the end, the California court made a

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ified by litigation solely between insured and insurance company.

[22] The court focussed upon the following factors, among others: (i) the agreement was described as a compromise solely between Technical Equities Corporation and National Union; (ii) the notice mentioned a $10 million liability limit suggesting a single policy amount and not the potential of three annual limits (as the court found to be the case); (iii) the notice did not suggest that $10 million in coverage could be eradicated by the

"fact-specific" determination that insulated the respondent Helfands from the *res judicata* plea of National Union.

> In a practical sense there was *no notice* that anyone was challenging or otherwise attempting to adjudicate the rights of officers and directors as insureds under the policy vis-a-vis their insurer. Therefore, these are not matters that "could have been litigated" at the compromise hearing. (*Chicot County Dist. v. Bank, supra,* 308 U.S. at p. 375 [84 L.Ed. at p. 333].) (PA 41a.)

Certainly, at bottom, it is this factual determination that forms the real basis of the dispute between petitioner and respondents. It is not a question of exclusive federal jurisdiction. It is not a question of state court subject matter jurisdiction. It is not a question of comity, federalism, or anything like that. It is simply a question of whether or not the state court's factual determination that the Helfands were not bound by the bankruptcy order under the doctrine of *res judicata* was correct. Two courts in California have spoken on this issue and this Court should not disturb those factual determinations.

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compromise; (iv) the notice did not target the individuals who were impacted by the third year policy proceeds; and (v) written objections were to be filed in a short period of time. PA 27a-29a, 32a, 36a-41a.

V. CONCLUSION

For all of the foregoing reasons, plaintiffs and respondents herein pray that the petition for writ of certiorari be denied.

DATED: July 22, 1993

Respectfully submitted,

COTCHETT, ILLSTON & PITRE
JOSEPH W. COTCHETT
SUSAN ILLSTON
MARIE SETH WEINER*
THOMAS T. ANDERSON & ASSOCIATES
THOMAS T. ANDERSON

Attorneys for Respondents and Plaintiffs Leonard and Eileen Helfand

*Counsel of Record

RESPONDENTS' APPENDIX

FILED
APR 14 1987

WILLIAM L. WHITTAKER
Clerk, U.S. District Court
Northern District of California
SAN JOSE

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

LEONARD HELFAND, et. al. Plaintiffs, vs. NATIONAL UNION FIRE INSURANCE CO. OF PITTSBURGH, PA, et. al. Defendants.	No. C 86-20855 SW ORDER GRANTING MOTION TO REMAND

Plaintiffs filed a complaint alleging negligent misrepresentation and breach of fiduciary duties against the directors and officers of Technical Equities Corp. (hereinafter referred to as TEC) after the firm filed for bankruptcy under Chapter 11. That action was coordinated with other similar complaints and is pending in Santa Clara County Superior Court.

Plaintiffs subsequently brought this declaratory relief action against defendant National Union, an insurance company which provided TEC with a $10 million liability

policy. Also named as defendants are nineteen TEC directors and officers, and DOES 1-100. The present action regards this insurance policy and the costs of defending the underlying claims against TEC. Plaintiffs claim that defendant National Union is deducting the costs of defending TEC's directors and officers from the policy limit, thereby depleting the $10 million fund. Plaintiffs seek a judicial determination of the interpretation and enforceability of the policy provision, and a judgment declaring that the $10 million does not include the costs of defending the directors and officers in the underlying actions.

This action was originally filed in state court. Defendant National Union subsequently removed the case to federal court on grounds of federal question and diversity jurisdiction. On March 6, 1987, this court took two motions under submission without oral argument: plaintiffs' motion to remand and defendant National Union's motion to dismiss.

MOTION TO REMAND

1) Diversity Jurisdiction

There must be complete diversity to invoke this court's jurisdiction pursuant to 28 U.S.C. § 1332, and it is the moving party's burden to prove that complete diversity exists. *Littlefield v. Continental Cas. Co.*, 475 F. Supp. 887, 889 (C.D. Cal. 1979). Plaintiffs are California residents, while defendant National Union is incorporated in Pennsylvania with its principal place of business in New York. However, seventeen of the defendants, all of whom are TEC directors and managers, are California residents.

National Union asserts that these defendants' interests are identical with the interests of the plaintiffs, and therefore asks this court to realign all defendants (except itself) as party plaintiffs. Plaintiffs move to remand this case to state court, claiming that this court lacks jurisdiction under § 1332 because their interests are not the same as the defendants' and realignment of the parties is inappropriate.

It is the court's duty to look beyond the pleadings and align the parties according to their interests in the litigation. *Indianapolis v. Chase National Bank*, 314 U.S. 63, 69-70 (1941). This requires the court to ascertain the "primary and controlling matter in dispute." *Id. at* 69. Thus, if the defendants' interests coincide with the plaintiffs' interests in relation to the purpose of the lawsuit, then the court must realign these defendants as party plaintiffs. *Dolch v. United California Bank*, 702 F.2d 178 (9th Cir. 1983).

Plaintiffs and the individual defendants do share at least one common goal: both parties want to preserve the $10 million to pay for any potential liability of TEC's directors and officers in the underlying actions. However, the individual defendants rely on defendant National Union's policy to pay for their defense costs, and in this action these defendants are primarily concerned with receiving funds for their defense in the underlying litigation. Conversely, plaintiffs' main purpose in this action is to ensure that the costs and expenses incurred in defending the directors and officers do not reduce the $10 million. This court does not agree with defendant National Union that the individual defendants' interests are identical with the interest of the plaintiffs, and therefore

declines to realign the parties. Therefore, this court finds that defendant National Union cannot invoke this court's jurisdiction pursuant to 28 U.S.C. § 1332.

2) Federal Question Jurisdiction

Defendant National Union also asserts that this court has jurisdiction over this case pursuant to 28 U.S.C. § 1334(b) because this action is "related to" a bankruptcy proceeding. However, this case seeks to interpret the language of the policy, and does not address the question of whether the policy proceeds are or are not assets of the bankruptcy estate. Because defendant National Union has not established that a relationship exists within the meaning of § 1334(b) between this case and any proceeding under the Bankruptcy Code, this court finds it does not have jurisdiction pursuant to § 1334(b).

MOTION TO DISMISS

Because the court has determined it lacks jurisdiction over this proceeding, it cannot rule on the merits of defendant National Union's motion to dismiss.

Accordingly, this court GRANTS plaintiffs' motion to remand this proceeding to state court.

IT IS SO ORDERED.

Dated: 4-13-87

s/
Spencer Williams
United States District Judge

[EXCERPT OF TRANSCRIPT OF
A BANKRUPTCY COURT HEARING]

UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

BEFORE: THE HONORABLE LLOYD KING, JUDGE

IN RE TECHNICAL EQUITIES CORPORATION, DEBTOR.	)	CASE NO. 3-86-00366LK CHAPTER 11
TECHNICAL EQUITIES CORPORATION, THROUGH ITS OFFICIAL UNSECURED CREDITORS' COMMITTEE, PLAINTIFF, v. NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA., ET AL., DEFENDANTS.	)	ADVERSARY PROCEEDING NO. 3-86-0449LK
AND RELATED CROSS AND COUNTERCLAIMS	)	

FRIDAY, OCTOBER 30, 1987 – 10:00 A.M.

REQUEST FOR INJUNCTIVE RELIEF
MOTIONS FOR CLASS CERTIFICATION
MOTION FOR FEES AND COSTS

* * *

THE COURT: All right. The matter is submitted and the request for this injunctive relief and Class Certification will be denied.

First, on the Interpleader Action there is the question of whether or not some injunctive relief is necessary for the protection of the fraud.

There are two basics [sic] problems with that.

First, because of the unresolved question of whether or not this is a self-consuming fund, it's not clear that protection is necessary.

And it's further clear that that question will not be resolved with the finality by the Courts of the State of California for a long time.

The question would appear to be one that's still important to all interests concerned.

Appeals are going to be pursued if the litigation is pursued and those will not be resolved swiftly.

Assuming that this is a self-consuming fund, there are competing interests of equal importance. Namely, the interests of those involved in the litigation in the coordinated litigation for want of a shorthand term.

Therefore, if it turns out that the fund is consumed it would appear that it would be consumed for a legitimate purpose and that the interest in preserving this fund is not of sufficient magnitude that injunctive relief is inappropriate.

Those same considerations really apply to the suggestion of any general injunctive relief based upon the

inherent or equitable or even the statutory power of the Court under the All-Risk Statute.

There are important competing interests on both sides.

Mr. Alexander's clients, particularly, I believe, are aggrieved parties by the failure to issue an injunction. Because, as the proceeds are consumed for their defense – if this is a self-consuming policy – then necessarily, the amount of proceeds available to satisfy any judgment exposure that they may have, is diminished.

Nevertheless, I understand that risk, that harm and – balancing the competing interests, feel that the injunctive relief is inappropriate.

As far as Class Certification is involved, I am in agreement with the argument, certain of the basic prerequisites of Rule 23-A are not met.

This Class is not so numerous that joinder of all the members is impractical and can be seen here.

And that's Sub-division 1 of Rule 23-A and also Subdivision 4 requires that the representative parties will fairly and adquately [sic] protect the interests of the Class.

As has been pointed out, there is a direct litigation beteween [sic] certain members of the proposed Class that would not be possible to get a representative to represent all.

And there seem to be numerous parties who have their own counsel. Those counsel have been involved in this litigation for a considerable period of time.

The efforts in the coordinated litigation are proceeding and the ability of single representatives to fairly and adequately protect the Class does not seem to be achievable.

I believe it goes without saying that I am dening [sic] the request of the Drysdale parties that a ruling on this motion be deferred pending the hearing before Judge Ingram. There may or may not be satisfactory alternatives.

I want to back up to the Class Certification question.

In view of the determination under Subdivision A of Rule 23, I don't find it necessary to discuss or pass upon the issues that the parties have raised about whether or not classes – specific kinds of classes can be maintained under Rule 23-B.

There may be alternative methods to that which is suggested as Mr. Benvenutti has pointed out correctly though. Even the alternative suggested by the Court has some inherent questions and is by no means a complete resolution.

There's a question frankly, about the focus on the Bankruptcy Court.

The interests of the Bankruptcy Court in this litigation is a little different and perhaps, somewhat diminished in view of the confirmation of the plan of reorganization.

This is not like some other major re-organizations where the settlement of class and securities' litigation becomes an integral part of the re-organization.

Here, the Bankruptcy Estate is basically a claimant along with hundreds of others.

And I don't think it's appropriate to over-emphasize the role of the Bankruptcy Court just because the Bankruptcy Estate or the Creditor's Committee is a party.

In the big picture which is the recovery of damages, the Estate in Bankruptcy is a competing claimant along with many others. But that's really all that it is. Whether or not these proceeds are property of the estate is a far from answered question.

I think that many serious points have been raised in the argument today that suggest that an affirmative answer to that question would take some doing.

And if anyone wants to raise that question I certainly would be happy to consider it and rule upon it.

I have considered the suggestion by Mr. Perlis and that is that there be a brief injunction to get the parties going toward settlement.

Efforts toward settlement have been going on for a long time in Court and even out of Court.

I notice that Barbara Phillips was here for a considerable portion of the hearing and I don't think that a brief stay is going to be an effective vehicle of bringing about a resolution.

If I thought it would bring everyone to their senses, that would be fine. But instead, I see the brief stay as perhaps more of an interference with the coordinated litigation than a positive step.

Somebody raised the point that I was presented with the alternative of an injunction or inaction or some such and I suppose that's true.

And it's necessary in litigation of this nature that judicially, a strong hand be taken. But here, frankly, the question is: Where should it be taken?

And again, I am persuaded that it has been taken. And if too many strong hands are taken then there can be confusion ultimately, rather than progress.

It's been suggested that this ruling may, in fact, render the Interpleader moot. And I think that is a legitimate prospect. And again, a prospect that has been considered and weighed.

The denial of the requests for injunctive relief and Class Certification is without prejudice to renewal should there be a determination that the Estate in Bankruptcy – let me put it differently.

That the proceeds of the policy, in fact, constitute property of the Estate.

And when I say "the proceeds of the policy" I in fact, mean either all or a portion of the proceeds of the policy.

Again, stressing that I am not at this point persuaded that there would be an affirmative answer to that question.

But certainly have not had an adequate opportunity, fully, to address that.

I believe that for purposes of Rule 52-A of the Federal Rules of Civil Procedure and Bankruptcy rule 7052, my

comments for the record will serve as a Statement of Reasons.

Mr. Buckley, will you please undertake to prepare an appropriate order?

I will not require that it be approved as to form because that process might make a substantial encouragement [sic] into the policy proceeds, I suspect.

Why don't you submit it with a transmittal letter, suggesting that it be lodged for a period of ten days to give other parties an opportunity to comment?

MR. BUCKLEY: I will, your Honor.

* * *

FILED
JAN 30 1991

RICHARD W. WIEKING
CLERK, U.S. DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA
SAN JOSE

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA, Plaintiff, v. AARONSON, DICKERSON, COHN & LANZONE, a Professional Corporation, *et al.*, Defendants.	No. C-90-20561-WAI MEMORANDUM OF DECISION

The application of plaintiff National Union for a preliminary injunction restraining the enforcement of any judgment which may be rendered against plaintiff in the six coordinated bad faith cases now on trial in Superior Court is denied.

The request of the Kouns defendants for a hearing of their request for sanctions against plaintiff for purported violation of Rule 11 F.R. Civ.P., is granted, but hearing is deferred until after trial on the issue of a permanent injunction, if there is such a trial.

This matter is here because the plaintiff seeks relief under the provisions of the third exception to the Anti-Injunction Act, 28 U.S.C. § 2283, and under the All Writs Act, 28 U.S.C. § 1651.

The judgment which plaintiff seeks to effectuate and protect is an order entered by the U.S. bankruptcy court for this district which approved a compromise between plaintiff herein, National Union Fire Insurance Co. and the debtor in possession in the matter then before the bankruptcy court, Technical Equities Corp.. The compromise concerned a dispute over National Union's cancellation of a policy issued by it to Technical Equities which insured the Directors and Officers of Technical Equities for a period commencing August 5, 1984 and expiring August 5, 1987 against claims made against the officers and directors. Technical Equities collapsed sometime in 1986 and filed for Chapter XI protection. After that National Union cancelled coverage for what was left of the second year of coverage, slightly less than a month, and all of the third year coverage. Technical Equities objected to this on the basis that the act of National Union violated the automatic stay. The parties resolved the dispute through compromise by the terms of which National Union cancelled the coverage above referred to, but issued a new policy covering the officers and directors for claims made after the bankruptcy was filed and was pending. The bankruptcy court held a hearing on that and other related matters pertaining to the Bankruptcy Estate on July 28, 1986 and approved the compromise.

Plaintiff now contends that the order constituted a judgment which is *res judicata* as between the parties to the compromise and to their privies and bars the entry of

any judgment against National Union in the presently ongoing state bad faith actions to the extent that the judgments are predicated on continuing coverage of the directors and officers for the policy period cancelled by National Union pursuant to the agreement of compromise.

The reason the case is here is that National Union has invoked two federal statutes, the Anti-Injunction Act, 28 U.S.C. § 2283, and the All Writs Act, 28 U.S.C. § 1651, in support of its effort to persuade this court to call a halt to an element of the ongoing state court proceedings.

The factual situation is rendered more murky than otherwise by the fact that the bankruptcy court judge, King, C.J., rendered subsequent decisions which strongly indicate that he had no intention of effecting matters of coverage, policy limits and the like, but was leaving such determinations to the state court judge who was presiding over the state coordinated proceedings.

For example on July 28, 1986 King approved the compromise over the D&O policy. On October 30, 1987 National Union sought a preliminary injunction from Judge King, enjoining the then ongoing state and federal actions. This request was refused. On April 29, 1988 National Union sought a Finding that the Order of July 28, 1986 had limited coverage under the D&O Policy to $10 million. This, and the accompanying motion for preliminary injunction of ongoing state and federal court litigation, were denied by King on June 22, 1988. The grounds for this denial are not readily apparent. On November 22, 1989 King ordered that the bankruptcy

court would retain jurisdiction over the CGL Policy proceeds and their administration, but that it would abstain from deciding issues of interpretation. On August 27, 1990 Judge Rushing entered judgment in the *Helfand* action, holding that the D&O Policy was not self-consuming and that its value was $10 million per policy year for each of the three years of coverage. In addition, Rushing ruled that the previous bankruptcy court order did not amount to *res judicata* against the plaintiffs in *Helfand*.

Little over one week later, on September 7, 1990, King tentatively granted the *Helfand* plaintiffs motion for complete abstention from determination of all remaining issues in the interpleaded action. This order was conditioned only upon the finding of a suitable mechanism to distribute the interpleaded funds.

All this causes me to wonder why plaintiffs chose this district court in which to seek injunctive relief rather than the bankruptcy court which made the order whose preclusive effect is in issue here. As was observed in *Bechtel Petroleum Inc. v. Webster*, 796 F.2d 252 (9th Cir. 1986),

> Judge Orrick was in the best position to assess the strength of this litigation as he was the same judge who presided over the federal FLSA enforcement proceeding which is the alleged basis for the res judicata preclusion.

The bankruptcy court has the power to exercise its discretion in acting on a motion such as the one presently before this court.

> The bankruptcy court is empowered to enjoin state court actions when it is appropriate under

> Code Section 105(a) which provides: 'The bankruptcy court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.' This section acts as 'authorization' as required by 28 U.S.C. § 2283, for a court of the United States to stay the actions of a state court. *In re McCools Boxed Beef Corp.*, Bkrtcy., 24 B.R. 462 (1982).

However, as plaintiff has pointed out, the case may properly be filed before this court.

A decision whether or not to enjoin a state court proceeding pursuant to the narrow exceptions of the Anti-Injunction Act is committed to the discretion of the district court.

> Doubts as to the propriety of a federal injunction against state court proceedings should be resolved in favor of permitting the state courts to proceed in an orderly fashion to finally determine the controversy. *Golden v. Pacific Maritime Association*, 786 F.2d 1425 (9th Cir. 1986); *Atlantic Coast Line Railroad Co. v. Brotherhood of Locomotive Engineers*, 398 U.S. 281 (1970).

The fact that a federal court has the power to enjoin state proceedings in order to protect its own does not mean that it is appropriate to exercise that authority in every instance. Whether an injunction should issue depends upon several factors including whether or not the issuance is in the interest of equity, comity and federalism. *United Transport Union v. Long Island Railroad*, 509 F.Supp. 1300 (E.D.N.Y. 1980).

After careful examination of all the filings before me and of the oral argument of counsel I am convinced that

basic principles of comity and federalism in this instance preclude issuance of a preliminary injunction.

With respect to the circumstances of the issuance of the Order and totality of actions taken with respect to the subject matter of the order there are troubling questions:

1. To what extent did defendants herein, who are plaintiffs in the actions sought to be enjoined, have notice of the proceedings in which the compromise agreement between National Union and Technical Equities was approved by the bankruptcy court? A quick review of the record shows, through the Affidavit of Michael F. Perlis, that 23 of the 1,571 investor plaintiffs were mailed notice.

2. To what extent were the investor defendants herein virtually represented at the hearing on the motion for approval of compromise? Present at the July 28, 1986 hearing were counsel for the Creditor's Committee and counsel for a putative class of investor who were allegedly defrauded by Technical Equities Corporation. However, those counsel were before the court on *other motions* unrelated to the motion for Approval of Compromise and did not participate in that motion. (See Ex. L to Declaration of Marie Seth Weiner). Far from being "virtually represented" for that hearing, the investor defendants herein were virtually unrepresented by anyone.

3. Was the form of notice adequate to inform those who were served with it as to the nature of the compromise, and the necessary effect of it on persons in the position of the investor defendants herein? Judge Rushing of the Superior Court has ruled that the notice was deficient. (See Declaration of Weiner, Ex. F, p.23).

4. Was there privity between the investor defendants herein and anyone who had notice of the hearing and represented the interests of the investor defendants herein with the authority to do so? (cf. *United States v. ITT Rayonier, Inc.*, 627 F.2d 996 (9th Cir. 1980).)

5. To what extent can contractual rights under an insurance policy be effectively cancelled as to parties aggrieved by the insured risks, where the risk insured against has occurred prior to the cancellation?

These and perhaps other questions have been presented to the Superior Court and are now presented to this court. Two companion cases to those here involved have been fully tried in Superior Court and are now on appeal to the California Court of Appeal for the First Appellate District, Division Four, and are not as yet determined. Those cases, *Helfand v. National Union, et al.*, No. 615589 and 654728, *McLaughlin v. National Union*, No. 666389, (coordinated under No. 600306), present the same issues that are presented in the instant proceedings. Those cases and the six coordinated cases sought to be enjoined have been pending for many years and have moved completely through the California court system to and including trial, and in two of the cases to and including judgment without any application of the sort now before this court having been made.

Enormous expenditures of time, effort and money have been made in connection with those cases. As indicated in Judge Rushing's *Helfand* opinion (Ex. F to Declaration of Weiner) many of the plaintiffs are elderly and have been accorded their statutory preference for rapid resolution of their cases.

The issues have been properly and squarely presented to the California Appellate courts.

It is worthy of note that the relitigation exception to the Anti-Injunction Act was aimed at preventing the costly and judicially wasteful determination of issues in state court after full litigation in federal court. *Quintero v. Klaveness Ship Lines*, 914 F.2d 717 (5th Cir. 1990). To the extent that this is a germane consideration it is without application in this case where, with the acquiescence of plaintiff, the cases sought to be enjoined have proceeded for years through the state courts and have been in trial since October, 1990. More than four years have passed since the entry of the bankruptcy court order in issue, and apparently no effort has ever been made to invoke the relitigation exception until late last year. The expense and effort shoe is precisely on the other foot in this instance. The effort and expense which led to the bankruptcy court order in issue is a drop in the bucket when compared to the time, effort and money devoted to the coordinated proceeding with respect to the cases involved in this proceeding.

As Judge Wisdom said in *Southern California Petroleum Corp. v. Harper*, 273 F.2d 715, 719 (5th Cir. 1960),

> We take the view that a complainant must make a strong and unequivocal showing of relitigation of the same issues in order to overcome the federal courts' proper disinclination to intermeddle in state court proceedings. If we err, all is not lost. A state court is as well qualified as a federal court to protect a litigant by the doctrines of res judicata and collateral estoppel.

Mindful that doubts as to the appropriateness of an injunction should be resolved "in favor of permitting the state courts to proceed in an orderly fashion to finally determine the controversy" (citation omitted) *Bechtel Petroleum Inc. v. Webster, supra.* I am strongly of the opinion that for the reasons stated, the doubts strongly outweigh the propriety of intervention.

Furthermore, in *Mitchum v. Foster,* 407 U.S. 225 (1972) the Supreme Court noted that in civil cases the court had not yet decided the precise parameters of exceptions to the Anti-Injunction Act. These were established in criminal case application by *Younger v. Harris,* 401 U.S. 37 (1971) but the Court noted that even where there is an apparently applicable exception the court to which the application is directed must consider the appropriateness of injunction relief in the light of principles of equity, comity and federalism.

Parsons Steel Inc. v. First Alabama Bank, supra goes a considerable distance in filling the void noted by the Court in *Mitchum* with respect to civil cases.

The case holds that after a final state court judgment is entered the Full Faith and Credit Act entitles the judgment to preclusive effect, meaning that federal courts must accord such a judgment the same effect as another court of the same state would give it. In such a situation the relitigation exception to the anti-injunction statute has no application at all, because to apply it would impermissably [sic] limit the Full Faith Credit Act.

Here the parties sharply dispute whether or not the judgments in *Helfland* [sic] and *McLaughlin* are to be

regarded as final even though the appellate decisions have not yet been rendered.

Plaintiff relies on *Agarwal v. Johnson*, 25 Cal.3d 932 (1979), *Camp v. Mendocino County Board of Supervisors*, 123 Cal.App.3d 334 and *People ex rel Gow v. Mitchell Brothers' Santa Ana Theater* 101 Cal.App.3d 296 (1980), all of which hold that a judgment is not final for res judicata purposes when appealed until the exhaustion of the appellate process.

Defendants rely strongly ont [sic] he [sic] language of *Parsons* at 474 U.S. 525,

> Challenges to the correctness of a state court's determination as to the conclusive effect of a federal judgment must be pursued by way of appeal through the state court system and certiorari from this Court.

Defendants suggest also that the conclusive effect of a judgment in a coordinated proceeding, such as the one here sought to be enjoined, provides an exception to the finality of judgment rule otherwise applicable because of the necessity of compliance with CCP 36(a) which is a mandatory provision requiring the trial of cases of elderly plaintiffs within a limited time after filing of the at issue memorandum. The practical result of the application of this exception is that the state trial court in the cases here sought to be enjoined employed offensive collateral estoppel to preclude the trial of certain issues which were decided adversely to plaintiff herein in the cases sought to be enjoined. This court does not express an opinion on these important questions of California law

because it is not necessary to do so in order to decide the instant case.

Whether the decision of the trial court constitutes a final judgment within the meaning of the *Parsons* case and constitutes an absolute bar to the application of the relitigation exception is not the predominant issue because even though it does not constitute such a bar, this is not a proper case for the application of the relitigation exception because to apply the exception and to grant the injunction would be an unwarranted and unconscionable intrusion upon California processes, wholly at odds with principles of federalism, comity and equity. Cf. *Mitchum v. Foster, supra.*

The aftermath of the Technical Equities bankruptcy including the number of suits and parties litigant, the age of many of those parties, the failure of plaintiff herein to seek this relief through the four or more years that the cases sought to be enjoined have pended, the surrounding circumstances of the issuance of the bankruptcy court order, the actions of the bankruptcy court following the issuance of the order of August 5, 1986, the lack of cognizable irreparable injury to plaintiff[1] have all been weighed by me, and I conclude that plaintiff's application must be denied, and IT IS HEREBY DENIED.

DATED: 1/ 28/ 91

s/
WILLIAM A. INGRAM
United States District Judge

[1]Although National Union has argued that a party seeking injunctive relief under the relitigation exception need not show irreparable injury in order to prevail, the cases cited in favor of this proposition do not actually state that an irreparable injury showing is not required. To the contrary, the court finds the defendants' position, that the same equitable standards apply to injunction obtained under the relitigation exception as apply to all injunctions, to be persuasive. Although neither *White Mountain Apache Tribe v. Smith Plumbing Co.*, 856 F.2d 1301 (9th Cir. 1988) nor *Goldie's Bookstore v. Superior Court*, 739 F.2d 466 (9th Cir. 1984) expressly state that irreparable injury must be shown, both directly imply this requirement by overturning injunction issued by the district court because no irreparable injury was demonstrated. *See also* C. Wright, A. Miller & E. Cooper, *Federal Practice and Procedure*, § 4226 at 551 (2d ed. 1988).

[EXCERPTS FROM THE *HELFAND* TRIAL TRANSCRIPT]

IN THE SUPERIOR COURT OF
THE STATE OF CALIFORNIA

IN AND FOR THE COUNTY OF SANTA CLARA

COURTROOM 100

BEFORE HONORABLE CONRAD L. RUSHING, JUDGE

IN RE TECHNICAL EQUITIES LITIGATION	COORDINATED PROCEEDINGS
	MASTER FILE NO. 1991
THIS DOCUMENT RELATES TO:	SANTA CLARA COUNTY SUPERIOR NO. 600306
HELFAND VS. NATIONAL UNION, ET AL., AND RELATED CROSS-ACTIONS.	
SANTA CLARA SUPERIOR NO. 615589	

SANTA CLARA, CALIFORNIA, MAY 22, 1989

9:15 O'CLOCK A.M.

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* * *

[MR. ROBINSON:] WITH RESPECT TO WHETHER OR NOT THE PLAINTIFFS WERE ENTITLED TO WITNESS, I AM NOT TALKING, NOW, ABOUT D AND O, BUT THE PLAINTIFFS, INJURED INVESTORS. THEY CLAIM THAT THEY WERE NOT PRESENT AT THE BANKRUPTCY HEARING AND, THEREFORE, THAT

SOMEHOW NEGATED THE VALIDITY OF JUDGE KING'S ORDER.

THE POINT IS PLAINTIFFS WERE STRANGERS TO THE CONTRACT, AND THE PLAINTIFFS HAD NO RIGHTS UNDER THE D AND O POLICY UNTIL THEY OBTAINED JUDGMENTS. AND AS OF AUGUST OF 1986 THERE WERE NO JUDGMENTS. YES, THEY HAD AN INTEREST IN THE POLICY PERHAPS AS ANY CONTINGENT CLAIMANT MIGHT HAVE, BUT THEY HAD NO RIGHT THAT THEY COULD DEMAND TO BE NOTIFIED AND, THEREFORE, THE LANGUAGE OF THEIR NOTICE IS IRRELEVANT TO THE EFFICACY.

THE COURT: WHOSE LACK OF NOTICE?

MR. ROBINSON: TO THE PLAINTIFFS THEMSELVES, THE INJURED PARTIES. THEY MAKE A BIG POINT OF SAYING, "WE WEREN'T THERE. THEREFORE, THE WHOLE PROCEEDINGS WERE CORRUPTED SOMEHOW WITH ERROR." AND I AM MAKING THE POINT THAT THEY WERE NOT ENTITLED TO NOTICE EVEN THOUGH THEY MAY OR MAY NOT HAVE HAD ACTUAL NOTICE. I DON'T KNOW WHAT THE STATE OF AFFAIRS WAS, BUT THERE WAS NO POLICY PROVISION THAT REQUIRED THAT THIRD PARTY CLAIMANTS, STRANGERS TO THE CONTRACT, BE NOTIFIED OF ANYTHING AFFECTING THE POLICY.

* * *

No. 92-1974

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA

Petitioner,

v.

LEONARD HELFAND and EILEEN HELFAND,

Respondents.

On Petition For Writ Of Certiorari To The California Court of Appeal, First Appellate District, Division Four

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REPLY MEMORANDUM

HORVITZ & LEVY
ELLIS J. HORVITZ
PETER ABRAHAMS*
STEPHEN E. NORRIS
15760 Ventura Boulevard
18th Floor
Encino, CA 91436-3010
(818) 995-0800 & (213) 872-0802

GIBSON, DUNN & CRUTCHER
THEODORE B. OLSON
THEODORE J. BOUTROUS, JR.
JEANNE M. HAUCH
1050 Connecticut Avenue, N.W.
Suite 900
Washington, D.C. 20036
(202) 955-8500

PETTIT & MARTIN
D. WAYNE JEFFRIES
SAUL D. BERCOVITCH
101 California Street
35th Floor
San Francisco, CA 94111
(415) 434-4000

STROOCK & STROOCK & LAVAN
MICHAEL F. PERLIS
2029 Century Park East
Los Angeles, CA 90067-3068
(213) 556-5800

ROBINSON & WOOD, INC.
ARCHIE S. ROBINSON
THOMAS R. FELLOWS
227 N. First Street, Suite 300
San Jose, California 95113
(408) 298-7120

Attorneys for Petitioner

**Counsel of Record*

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

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REPLY MEMORANDUM

Petitioner National Union seeks summary reversal of the decision below of the California Court of Appeal, which nullified an order of a United States Bankruptcy Court regarding a matter within the exclusive federal bankruptcy jurisdiction. In opposition, respondents make two arguments: (1) that the state court had subject matter jurisdiction to decide that respondents are "not bound" by the bankruptcy court's order approving an agreement between the debtor and National Union canceling and revising the debtor's insurance coverage because respondents were not "parties" to the bankruptcy proceedings; and (2) that the California court did not actually nullify the bankruptcy order, but rather correctly interpreted the "scope" of its "binding effect." *See* Opp. at 1-2. Both arguments are meritless, and this Court should summarily reverse to rectify what is a clearly erroneous, extraordinary and flagrant intrusion by the California courts into an exclusively federal domain.

1. Respondents are unable to cite a single case that holds that a state court has subject matter jurisdiction to entertain a collateral attack on a federal bankruptcy court order disposing of property that is part of the debtor's estate. That is because the courts—federal and state—have uniformly rejected that argument. *See* Pet. at 17-18. Indeed, the California Court of Appeal itself has squarely held that " 'Congress' grant to the federal courts of exclusive jurisdiction over bankruptcy petitions *precludes* collateral attacks on such petitions in state courts.' " *Gene R. Smith Corp.* v. *Terry's Tractor, Inc.*, 209 Cal. App. 3d 951, 954, 257 Cal. Rptr. 598, 599 (1989) (citations

omitted; emphasis added), *cert. denied*, 494 U.S. 1016 (1990).[1]

Respondents are therefore left to argue that the California Court of Appeal had jurisdiction here to allow respondents to enforce an insurance contract that had been canceled by the bankruptcy court because state courts are empowered to determine the "*res judicata* effect of a prior federal judgment." Opp. at 17. According to respondents, the California court was entitled to decide that respondents "are *not bound*" by the bankruptcy order, Opp. at 18 (emphasis in original; citation omitted), despite its otherwise binding effect because respondents "were not parties to the bankruptcy litigation, had not received adequate notice thereof, and did not appear therein."[2]

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[1] The principal cases relied on by respondents are inapposite. For example, *Shapiro* v. *Republic Indemnity Co. of America*, 52 Cal. 2d 437, 341 P.2d 289 (1959) (Opp. at 7, 8, 21), is not a bankruptcy case and concerned an initial suit in state court followed by another suit in state court, rather than a bankruptcy determination in a federal court followed by a state-court suit. Nor did *Parsons Steel Inc.* v. *First Alabama Bank*, 474 U.S. 518 (1986) (Opp. at 2, 17, 19, 22) involve issues relating to the exclusive bankruptcy jurisdiction of the federal courts. The proposition cited from *Parsons*, 474 U.S. at 525—that challenges to the correctness of a state court's determination as to the conclusive effect of a federal judgment must be pursued by way of appeal through the state-court system (rather than federal court injunction of the state-court proceedings) and certiorari from this Court—describes exactly the course that National Union is now pursuing. *Parsons* thus in no way undercuts or even relates to National Union's argument that respondents could obtain relief only in the bankruptcy court because all other courts lacked jurisdiction.

[2] Respondents advanced this argument, and the court below accepted it, even though respondents' claim for an additional $10,000,000 of coverage pursuant to the canceled policy is based

Opp. at 18-19. That, however, is a classic collateral challenge to the bankruptcy court's judgment that could be made, if at all, *only* in the federal courts that had exclusive subject matter jurisdiction over the insurance policy cancellation. Indeed, whatever power state courts ordinarily may possess to make determinations with respect to the binding effect of federal judgments generally, that authority is completely lacking in the bankruptcy context. Pursuant to the Bankruptcy Clause of the Constitution, Congress has created an exclusive federal vehicle for making such challenges that respondents chose to ignore. *See* Pet. at 18-20. Congress thereby "oust[ed] the jurisdiction of the State court" and that renders the judgment below "not merely erroneous but . . . beyond [the State court's] power, void." *Kalb* v. *Feuerstein*, 308 U.S. 433, 438 (1940).[3]

---

on assignments from the directors and officers of the debtor, who were parties to the bankruptcy proceedings. Pet. App. 36a.

[3] "It is clearly within Congress' powers to establish an exclusive federal forum to adjudicate issues of federal law in a particular area that Congress has the authority to regulate under the Constitution," *International Longshoremen's Assoc.* v. *Davis*, 476 U.S. 380, 388 (1986) (citing *Kalb*), and "[e]nactment of such exclusive jurisdiction must, by operation of the Supremacy Clause, pre-empt conflicting state-court jurisdiction." *Id.* at 394 n.11. Although National Union repeatedly argued below that the California courts were intruding on the exclusive federal bankruptcy jurisdiction (Pet. App. 110a, 116a, 119a-26a, 141a-45a, 160a-66a, 171a-75a, 182a-85a), respondents complain that it did not make the precise jurisdictional argument below that it raises in this Court. Respondents do not, however, assert that National Union waived the subject matter jurisdiction point, and for good reason. Where, as here, Congress sets up an exclusive federal jurisdictional scheme, that constitutes "a nonwaivable foreclosure of the state court's very jurisdiction to adjudicate." *Longshoremen*, 476 U.S. at 389.

2. Respondents' argument that the California courts "in no way ignored the bankruptcy order or declared it a nullity," Opp. at 20, is equally unavailing. Indeed, respondents' own opposition leaves no doubt that the proceedings below with respect to the third year of coverage under the canceled insurance policy had but one purpose and consequence: to sweep aside the bankruptcy court's order to permit respondents to collect insurance proceeds that had been extinguished by that order.

Although the bankruptcy court explicitly held that adequate notice had been "provided to *all* parties entitled thereto," Pet. App. 199a (emphasis added), respondents concede that the inquiry below focused on—and reversed—the bankruptcy court on precisely that issue: "[w]ere the [respondents] given a full and fair opportunity to appear in the bankruptcy proceedings and protect their interests?" Opp. at 22. Respondents also concede that, had the California courts agreed with the bankruptcy court that notice of the bankruptcy proceedings leading to cancellation was sufficient, respondents "*would have* been bound." Opp. at 20 (emphasis in original).

Similarly, whereas the bankruptcy court order approved the agreement canceling the insurance policy, the California trial court ruled that it "is not bound by the Bankruptcy Court's . . . order even if it purports to authorize the cancellation." Pet. App. 81a. The Court of Appeal affirmed, concluding that National Union had a right to cancel the policy in "good faith" but that it "did not act in good faith in seeking cancellation" from the bankruptcy court, Pet. App. 34a, and that the "new deal" approved by the bankruptcy court was "arbitrary" because it "solely ben-

efited National Union and [the debtor]." Pet. App. 51a. State courts are not, however, vested with authority to decide whether a party to a bankruptcy proceeding acted in "good faith" or "bad faith" or whether a compromise approved by a bankruptcy court arbitrarily benefited the debtor and its creditors at the expense of third parties:

> Such an exercise of authority would . . . subvert the exclusive jurisdiction of the federal courts by allowing state courts to create their own standards as to when persons may properly seek relief in cases Congress has specifically precluded those courts from adjudicating.

Gonzales v. *Parks*, 830 F.2d 1033, 1035 (9th Cir. 1987) (only remedy for alleged "abuse of process" in connection with bankruptcy proceeding was to file motion for sanctions of "bad faith" litigation conduct in federal court).

Finally, the practical effect of the decision below makes clear that the California courts have nullified the bankruptcy order. The bankruptcy court order approved a compromise agreement by which the existing director and officer liability policy was canceled, a new policy covering the directors and officers for post-bankruptcy acts was substituted and no other premium was due for the additional coverage. Pet. App. 196a-97a. But the California Court of Appeal affirmed a finding that the cancellation was *invalid*, that the policy *remained in effect*, and that the post-bankruptcy directors and officers were entitled to coverage under the new policy *only* if the debtor paid National Union an *additional premium*. Pet. App. 88a.

Consequently, even the trial court has candidly recognized that it nullified the bankruptcy court's order approving the compromise. In *McLaughlin* v. *National Union*, A05115 (Cal. Ct App.) (appeal pending), one of the insurance bad faith actions against National Union which followed this action, the trial court instructed the jury: "Cancellation of the third year of the D&O policy was *invalid*, and had no effect on plaintiffs herein, *a bankruptcy order to the contrary notwithstanding*." Pet. App. 29a-30a, 201a (emphasis added).

August 2, 1993

Respectfully submitted,

HORVITZ & LEVY
ELLIS J. HORVITZ
PETER ABRAHAMS*
STEPHEN E. NORRIS
15760 Ventura Boulevard
18th Floor
Encino, CA 91436-3010
(818) 995-0800 & (213) 872-0802

GIBSON, DUNN & CRUTCHER
THEODORE B. OLSON
THEODORE J. BOUTROUS, JR.
JEANNE M. HAUCH
1050 Connecticut Avenue, N.W.
Suite 900
Washington, D.C. 20036
(202) 955-8500

PETTIT & MARTIN
D. WAYNE JEFFRIES
SAUL D. BERCOVITCH
101 California Street
35th Floor
San Francisco, CA 94111
(415) 434-4000

STROOCK & STROOCK & LAVAN
MICHAEL F. PERLIS
2029 Century Park East
Los Angeles, CA 90067-3068
(213) 556-5800

ROBINSON & WOOD, INC.
ARCHIE S. ROBINSON
THOMAS R. FELLOWS
227 N. First Street, Suite 300
San Jose, California 95113
(408) 298-7120

Attorneys for Petitioner

**Counsel of Record*